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Date June 16, 1917.

Professors Ely and Scott having read and approved this thesis, I am very glad to sign it, even though I have not had opportunity to read it over carefully. T.K. Urdahl

To Professors:

Ely ....

Scott ....

Usdahl ....

....

This thesis having been approved in respect of form and mechanical execution is referred to you for judgment upon its substantial merit.

Geo. C. Comstock ....
Dean

LEGAL THEORIES OF PROFIT

BY

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LEGAL THEORIES OF PROFIT[1]

FOR centuries jurists and economists have studied the subject of profits, and their general analysis of the entrepreneur's income has grown constantly more complex. During the medieval period, the fair price of a commodity in England was its customary exchange value; and town guilds, common law courts, and even writers on industrial questions usually treated profit as a return for labor and effort spent in the production of economic goods. This was obviously a labor concept, but in many discussions of the time there appeared the risk theory, which conceded to the entrepreneur a return for the risk and trouble of employing capital productively. Indeed, both the labor and risk concepts of profit are to be found in the writings of the English and American economists down to this day; but in comparison with other profit theories, the former has occupied until recently the most secure position in the fields of law and economics. Stated concisely, one group of modern economists takes a conservative view of the entrepreneur function, and by a simple method represents his residual surplus as massed into a single but complex labor product, with many peculiarities.

In distinct contrast to this well-established view has arisen a more recent surplus-value theory, which explains the entrepreneur's profit as an unearned residual income above cost of production, and as largely the result of dynamic changes in industry. This important tenet has, therefore, found sufficient reason for its existence in the evolution of modern conditions; and the permanent foothold which it has secured in economic thought makes it an important element in any thorough analysis of the entrepreneur's income. To be sure, other modern doctrines of considerable importance present a variety of views which resemble more or less the labor theory, on the one side, or the

[1] By permission of the POLITICAL SCIENCE QUARTERLY this article appears simultaneously in the *Columbia Law Review* for June, 1918.

surplus concept on the other; but it is the unusual importance and the wholly irreconcilable nature of these two main theories that have forced upon jurists and economists alike an inevitable division in economic thought, and made the subject of profits a burning question. Each theorist is partly right. But obviously the labor concept of profits cannot embrace the vast unearned surpluses of to-day arising from restraint of trade and predatory conquest. Neither is any surplus theory of profits scientifically sound which classifies as unearned the differential returns from reduced costs of production. Surely more efficient technical processes or better inventions yield a definite measure of earned income.

Clear it is, then, that no one view of profits is wholly correct; and the legal theories of this residual surplus, which are already established in our common law, are, therefore, presented here as one step in the task of distinguishing fundamental concepts of the entrepreneur's various increments. The income known in law as profits resembles much a stream with many tributaries. It may include concrete things; as, payments in kind, services, soil, and objects beneath the surface of the earth, on the one hand, and such wholly unreliable returns as may fall to the hand of the gambler on the other. And whether the entrepreneur devotes his activities to the field of agriculture, commerce or manufacturing—or to any of their allied pursuits—this income appears to flow constantly from numerous sources which depend more or less on the adjustment of natural and social forces. In fact, it may be said that the many accretions from the operation of industrial forces really make up gross profits, but courts of law seldom tarry over the gross income; the terms "rents" and "profits" are usually interpreted as meaning "net profits." A much-quoted opinion defines profits as the excess of receipts over the expenditures necessary to earn them; but the apparent simplicity of this legal formula is soon lost sight of in the solution of practical problems. In striking this balance between the total income and the outgo, divers methods of arriving at the final result have given us several concepts of profits; and in studying the general plan of profit analysis, as a whole, the economist is impressed by the increas-

ing tendency on the part of American courts to obliterate the well-known distinctions which writers on economic theory have maintained for a century between profits, rent, and interest.

I

American judges have not taken kindly to the labor concept of profits, which represents this income as primarily one form of the wages of labor. This fact may be due in a measure to their failure to read the early common-law cases, and to their superficial examination of the works of the classical economists. That is to say, inexact definitions, drawn from these writers on the subject of profits, have been carried in legal opinions for generations, working unique effects in the distribution of wealth.

The more common of these interpretations conveys the terse statement that profit denotes the difference between the value of the advances and the returns resulting from their employment. By the term "advances" the courts doubtless have in mind here simply the outgo of the entrepreneur as expenses of production. And the amount represented by the phrase "returns resulting from their employment," may be assumed as equivalent to the gross income of the entrepreneur. This definition was probably taken from the early discussion of profits by Thomas Malthus; and if we stop to consider the slow progress made previous to this time in economic theory, it was not an unhappy expression of this theory of profits. But in constructing a more scientific definition of profit, courts have used the writings of these early economists authoritatively to eliminate the wages of superintendence from the entrepreneur's profits. Thus the supreme court of California includes, among other definitions of profit, a common interpretation from the works of Adam Smith[1] and J. S. Mill.[2] The definition of the court runs thus:

In distinction from the wages of labor, it is well understood to imply the net return to the capital or stock employed, after deducting all the expenses, including not only the wages of those employed by the

[1] Wealth of Nations, bk. i, ch. 6.

[2] Political Economy, ch. 15.

capitalist, but the wages of the capitalist himself for superintending the employment of his capital stock.[1]

This is an erroneous interpretation of J. S. Mill's definition; it has been accepted by the courts without troubling themselves to refer to the exact words of that learned economist, whose statement is, in fact, quite the contrary.

The line drawn between wages and profits in this interpretation may be taken as a modern, though not undisputed, theory in legal history. Yet it was used as early as 1828 in separating the various issues and incomes from land. The income of an estate meant nothing more to a court in Maine than the profits that it would yield after deducting the charges of *management*. The rent which could thus be obtained from this estate was its income; for, said the court, "The rents and profits of an estate, the income, or the net income of it, are all equivalent expressions."[2] This hostility toward a labor theory of profits is more clearly expressed in Illinois. In 1878 its supreme court was of the opinion that compensation for the labor of the officers of a corporation could not be regarded as profit within the meaning of the law. Profit in its ordinary sense was construed to mean the gain from any business or investment—"a different thing altogether from mere compensation for labor."[3] Highly significant is the fact that this modern tendency to discard the ancient labor concept of profits, is following gradually a process of elimination in which the final surplus, or remaining profit going to the entrepreneur, will finally be largely an unearned increment. That is, except for the worry and risk taken in connection with a business, there will be no human sacrifice recognized in law to which it may be attributed by either judge or jury.

Yet it seems that academic authority is not entirely responsible for this result. Bouvier's *Law Dictionary* states:

Profits are divided by writers on political economy into gross and net,

[1] People *v.* Savings Union (1887) 72 Cal. 199, pp. 202–203, 13 Pac. 498.

[2] Andrews *v.* Boyd (1828) 5 Me. 199, p. 203; see also Earle *v.* Rowe (1853) 35 Me. 414, p. 420.

[3] Commercial League etc. *v.* People (1878) 90 Ill. 166, at p. 173.

—gross profits being the whole difference between the value of advances and the value of returns made by their employment, and net profits being so much of that difference as is attributable solely to the capital employed. The remainder of the difference, or in other words, the gross profits minus the net profits, has no particular name, but it represents the profits attributable to industry, skill and enterprise. See Malthus, Political Econ.: M'Culloch, Political Econ. 563.[1]

It will be noted that the "remainder of the difference" which has no particular name, but is imputed here to some form of activity, skill or enterprise on the part of the entrepreneur, is really a modern interpretation of the labor concept of profit. Yet the author does not explain this profit as a particular form of labor wage. The truth is that this interpretation was originally taken from two early works on economics, and it illustrates well the persistent hold which previously accepted theories often retain in modern law. To be more explicit, it is said on the same page, in reference to the teaching of Adam Smith and J. S. Mill, that profits imply the net return to the "capital of stock" employed after deducting all the expenses, including the wages of the capitalist himself; and, to quote the author's exact words, "After indemnifying the capitalist for his outlay, there commonly remains a surplus, which is his profit, the net income from his capital. 1 Mill. Polit. Econ. c. 15." Now if the author of these excerpts had read carefully chapter 15, book ii of J. S. Mill's work on *Political Economy*, he would have found that the nameless surplus which he has thus separated from the return to capital is called "wages of management"—a fact which the courts have several times denied. These excerpts but emphasize one of the many anomalies of the law that arise through inexact quotations from previous authorities both legal and economic.

Again it is necessary at this point to draw attention to another exception to this rule of the law; for the foregoing opinions against the labor concept of profits do not occupy undisputed possession of the field. In rendering damages for injury to property, courts of law include wages of management as a part

[1] Bouvier, Law Dictionary (Rawle's 3rd rev.) 2737.

of the profits of an enterprise. The rule of compensation for damages was probably first applied in very early cases to the earnings of the laborer and the strictly professional man. That is, we find that the value of their services was often estimated as profits. And there is now a well-established rule of law which allows the entrepreneur to recover compensation for any injury to his income from the wages of superintendence and management. In fact, in estimating the amount of damages due to loss of profits, personal earnings rather than the income from capital are usually preferred in establishing the legal rule of compensation. In this relation the decisions of several states have been quite uniformly against the recognition of profits on capital. This tendency is, of course, of great significance; for the courts have given us a remarkable series of legal data which serve to distinguish the personal earnings of the entrepreneur, and consequently to give them a secure legal position in law as profits. This same attitude, however, is sometimes taken by judges in cases arising outside of the field of damages. One example will probably make this point plain. In deciding upon the right of a state to levy a tax upon the profits of a merchant's stock in trade, the supreme court of Massachusetts in 1870 distinguished between the income from a profession, trade or employment, which was already taxable, and that arising from capital invested as stock in a business. The court declared:

> The income meant by the statute is the income for the year, and is the result of the year's business. It is the net result of many combined influences: the use of capital invested; the personal labor and services of the members of the firm; the skill and ability with which they lay in, or from time to time renew, their stock; the carefulness and good judgment with which they sell and give credit, and the foresight and address with which they hold themselves prepared for the fluctuations and contingencies affecting the general commerce and business of the country. To express it in a more summary and comprehensive form, it is the creation of capital, industry and skill.[1]

It seems clear at this point that the modern concept of

[1] Wilcox *v.* County Commissioners (1870) 103 Mass. 544, at p. 546.

profits, as a return from the personal labor of the entrepreneur, will always be used by the courts in determining the rule of compensation in injury to property. And it is equally plain that the obvious departure from the labor concept of profit, which we have previously noted, was due largely to a hasty misconstruction of J. S. Mill's definition of profit. There is, in fact, no ground in Mill's work for the statement that wages of management are excluded from profits.

But the opinions against the labor concept of profits are also in conflict with many ancient and modern decisions on this point. In 1882 a court of Ontario held strictly to the labor concept embodied in a previously accepted definition of the word "profits": "In a wider sense it means, according to the Imperial Dictionary," explained Chief Justice Spragge, "'any advantage, any accession of good from labor or exertion.'"[1] Somewhat later it was pointed out in the opinion of a court of Pennsylvania that profits derived from the management of a business enterprise were not equivalent to total earnings. To be sure, the word "earnings" was interpreted narrowly according to the definition cited from Anderson's Law Dictionary[2] as "the fruit or reward of labor, the price of services performed."[3] In the conclusion, however, profit seems here to have been made equal to the total net gain of an enterprise, but depending largely upon other circumstances than the earning capacity of the manager. The opposite idea is, however, put more tersely by this same court in another decision. It is said, indeed, that in many instances profits derived from the management of a business may properly measure its earning power. Especially is this true, emphasized the court, if the enterprise receive the personal attention and labor of the owner.[4]

Turning to other examples, the medieval labor concept of profit is also retained in various cases in which the right to commissions on property sold by an agent is adjudicated. In

[1] Workman *v.* Robb, Ont. App. Rep. 399, 400, 404.

[2] At p. 390.

[3] Goodhart *v.* Pennsylvania R. R. (1896) 177 Pa. 1, at p. 15, 35 Atl. 191.

[4] Wallace *v.* Pennsylvania R. R. (1900) 195 Pa. 127, at p. 130, 45 Atl. 685.

English law, commissions, which would accrue to public agents for the sale of merchandise, were regarded as profits, and could be insured as such.[1] In two instances the right of a person to participate in the commissions of a business, was held to make him a partner.[2] In the United States a commission charged for the sale of western land was construed by the supreme court of Washington to be profits and a part of the net returns.[3] In like manner, where the sale of a copyrighted map was an infringement upon the rights of the owner, the commissions derived from the improper act were distinguished as a part of the profits and turned over to the plaintiff in the case.[4]

There are, of course, many conflicting decisions on this point, yet in the face of other profit theories, the labor concept is gradually losing its place in the legal field; for the returns upon all higher forms of mental and physical labor are being gradually merged into wages. But the net profit surplus, above wages of management, at which jurists are gradually arriving by this process of elimination—the excess of value returns over advances—remains to them still a complex subject.

II

The rent concept of profit as simply a return from land holds a very substantial position in English and American law; it has, in fact, come down to us from medieval times. In its original meaning, rent was defined as a sum of money, or other consideration, issuing yearly out of lands or tenements; or again, it was said to be a part of the profits of such property, paid not necessarily in money, product or labor—which were frequently rendered for rent—but in anything which could be regarded as a fixed amount or be reduced to a certainty.[5] Con-

[1] Lucena *v.* Crauford (1802) 3 Bos. & Pul. 75, reversed on its facts in the House of Lords. (1806) 2 Bos. & Pul. N. R. 269.

[2] Waugh *v.* Carver (1793) 2 H. Bl. 235; Cheap *v.* Cramond (1821) 4 B. & Ald. 663; Young *v.* Axtell (1784) cited in Waugh *v.* Carver, *supra*, at p. 242.

[3] Cooke *v.* Cain (1904) 35 Wash. 353, at p. 359. 77 Pac. 682.

[4] Stevens *v.* Gladding (C. C. 1856) 23 Fed. Cas. No. 13, 399.

[5] Co. Lit. 47a, 142, 142a; Smith *v.* Colson (N. Y. 1813) 10 Johns. 91; Gilbert, Rents 87; Browning *v.* Beston (1556) 1 Plow. 131, at pp. 132, 138, 141; 2 Bl. Comm. *42, *43; Minor Inst. 32–43.

sequently, the fact that rent was fixed and issued only out of land served to distinguish it from other forms of profit obtained either from the land or from the chattels on it. Thus Lord Coke states that if a house and land "with a stock or sum of money rendering rent" be demised for a term of years, "the assignee shall not be charged with this covenant: for although the rent reserved was increased in respect of the stock or sum, yet the rent did not issue out of the stock or sum but out of the land only."[1] This "stock or sum," as used in his excerpt, is an independent factor, and does not, therefore, include the buildings on the land, for these are tenements and virtually a part of it. Rent issues, of course, from the tenements, and to this extent it may be conceded that legally it arises from the use of capital. But rent could not be reserved out of any chattel, office, fair, market, common, franchise, privilege, tithe or advowson.[2] Indeed, from the numerous cases involving the payment of rent, it is clear that it was only by the most careful discrimination that early English judges were able to keep the rent profit entirely distinct from the income of stock or chattels.

The question whether rent may ever originate in the use of the stock obtained by the tenant with leased premises is, of course, not new to American jurists; and a most difficult issue has arisen over the doctrine of apportionment, namely, whether there should ever be a deduction of the rent in case the tenant suffers a loss on his leased stock. To allow an apportionment of the rent according to this loss would obviously extend the rent concept to chattels and, therefore, in effect, break the ancient rule. An English authority[3] cites a specific instance in which all of the sheep on certain leased premises had died. He is inclined to think that under such circumstances the rent would not be apportioned; for although it was naturally increased by the profits which arose from the sheep, "it may be doubted, whether the Rent shall be abated, while The tenant

[1] Spencer's Case (1583) 5 Coke 16a, at p. 17a; See Commonwealth *v.* Contner (1852) 18 Pa. 439; Fay *v.* Holloran (N. Y. 1861) 35 Barb. 295, at p. 297; Minor Inst. 34.

[2] Co. Lit. 47a, 142a, 144a; 2 Rol. Abr. 446.

[3] Gilbert, Rents, 187-188, citing Richards le Taverner's Case (1544) 1 Dyer *56.

enjoys all the Land out of which the Rent issues." This opinion was known to the supreme court of Virginia which departed from the established principle in 1808. Action for rent was brought against one who was entitled by a lease to the services of both a mill and the miller. But the latter having been given his freedom according to law declined to continue in the service of the lessee. Although the court acknowledged that it had found no case expressly in favor of the opinion which it entertained, yet it was of the belief that the jury could have apportioned the loss which the tenant had sustained by the departure of the miller.[1] However, in a later case it would seem that the court purposely evaded giving an opinion on this exact point.[2] Also, in Pennsylvania the change in the established doctrine of apportionment came suddenly. In 1852 we find the supreme court of that state declaring, according to the accepted theory, that "a sum of money, payable periodically for the use of chattels, is not RENT in any legal sense of the word."[3] But four years later the ancient principle was repudiated. In the opinion of the court:

> The ordinary definition of rent, as a profit issuing yearly out of lands and tenements corporeal is defective in overlooking some of the cases that belong to the class; as where a furnished house or a stocked farm is leased, which are common cases: 5 *Bos. & P.* 224; 5 *Co.* 16b; 1 *Leon.* 42. In such cases the personal property is really a part of the consideration of the rent, and it is only by fictitious accommodation of the case to the defective definition, that it can be said that the rent issues exclusively out of the land. It is better to correct the definition.[4]

By persisting in this view, the courts of Pennsylvania have affixed the rent concept more or less permanently to capital; but it need hardly be repeated that this theory is an exception to the general rule now prevailing in the United States.

[1] Newton *v.* Wilson (1809) 13 Va. 470.

[2] Scott *v.* Scott (1868) 59 Va. 158.

[3] Commonwealth *v.* Contner, *supra*, footnote 1, p. 192, at p. 447.

[4] Mickle *v.* Miles (1856) 31 Pa. 20, at p. 21; see also Vetter's Appeal (1881) 99 Pa. 52, at p. 55.

At the present time the rent concept of profit may still be distinguished from other ideas of profit by the frequent declaration that rent is a fixed yearly return issuing only out of the land.[1] And by an ancient *dictum*, it is not to be considered a part of the land or thing out of which it issues.[2] In contrast to rent, other profits are said to be the residual surplus from various sources fluctuating and uncertain in character, and depending on skill, care and the nature of the business transaction.[3] Yet a dangerous tendency to fuse the incomes of land is not entirely absent. In referring to previous quotations, which it had gathered from various decisions, the supreme court of New York in 1903 declared: "There is no such technical or peculiar meaning to the phrase 'rents and profits' as to deny a synonym in 'profits and gains.' A rent is a profit, and the profit in rents and profits is a profit still."[4] Stated concisely, the situation is simply this: the courts of one state are striving to differentiate the concepts of profit, while the judges of another state are consciously synthesizing the same ideas. But in general one is fully impressed by the important fact that although the legal theory of rent is obviously a productivity concept, it is, nevertheless, still confined to land and its tenements.

[1] Fay *v.* Halloran, *supra*, footnote i, p. 192, at p. 297; Stephens *v.* Reynolds, (1852) 6 N. Y. 454, at p. 458; Dolph *v.* White (1855) 12 N. Y. 296, at p. 300; Sutliff *v.* Atwood (1864) 15 Ohio St. 186, at pp. 192–193; Jones *v.* Smith (1846) 14 Ohio 606, at p. 608; Van Wicklen *v.* Paulson (N. Y. 1853) 14 Barb. 654; Bloodworth *v.* Stephens (1875) 51 Miss. 475, at p. 480; Boyd *v.* McCombs (1846) 4 Pa. 146; Ivy *v.* Gilbert (1722) 2 P. Wms. *13; Attorney General *v.* Foundling Hospital (1793) 2 Ves. Jr. 42, at p. 48; Armstrong *v.* Cummings (N. Y. 1880) 58 How. Pr. 331.

[2] Browning *v.* Beston, *supra*, footnote 2, p. 192, at p. *132.

[3] Bennett *v.* Austin (1880) 81 N. Y. 308, at p. 319; Last *v.* London Assurance Corp. (1885) 10 App. Cas. 438, at p. 450; Mersey Docks *v.* Lucas (1883) 8 App. Cas. 891, at p. 905; Freeman *v.* Freeman (1886) 142 Mass. 98, at pp. 99–100, 7 N. E. 710; Rogers-Ruger Co. *v.* McCord (1902) 115 Wis. 261, at p. 265, 91 N. W. 657; Jones *v.* Davidson (1854) 34 Tenn. 447, at p. 452; Owston *v.* Ogle (1811) 13 East 538; Hitchcock *v.* Tremaine (1872) 12 Fed. Cas. No. 6, 540.

[4] Thorn *v.* De Breteuil (1903) 86 App. Div. 405, at p. 416, 83 N. Y. Supp. 849.

III

The capital concept of profit is used here in a broad sense to include the growth or increase of capital itself by accretions of product or earnings. As all products are capital to the economist, while they are still devoted to production, and as all earnings are capital to the business man, until they are declared to be dividends, this concept of profit represents simply the additions to capital created through productive effort. Courts seldom go to the trouble of separating the exact annual output of capital from the previous total concrete mass used in production; distinctions of this sort are usually beyond their sphere. Moreover, judges also recognize that the earnings of a business are often turned back into the original fund of capital, which goes on its ceaseless round, its constant transformations, and its definite wealth-producing cycle.

This concept of profits crops out at unexpected angles from either the simple natural economy of the farm or the more active fields of finance in the commercial world. By way of illustration, the lessee of certain premises in Ontario erected thereon suitable buildings for use in his own trade, which were intended to go ultimately to his landlord in payment of rent. Obviously, both in a legal and an economic sense, these structures were capital. Although the court hesitated to call them rent, it did nevertheless rule that they were profits which were finally to become possessions of the landlord. In this sense, therefore, profits took the form of concrete products which were already devoted to further production. Indeed, in the opinion of Mr. Justice Spragge there was no necessity for restricting the word "profits" to a periodical return from the land, though that was conceded to be its common meaning. The decision states that "In a wider sense it means, according to the Imperial Dictionary, 'any advantage, any accession of good from labor or exertion.' In that sense Robb received a profit every time that a building or addition to a building was placed upon his land."[1] In this, as well as in other opinions, judges have simply reverted to the medieval method of meas-

[1] Workman *v.* Robb, *supra*, footnote 1, p. 190, at pp. 400, 404.

uring profit in terms of product or payment in kind. In a case in Connecticut the phrase "profits from the farm" was construed to comprise, not only net profits, but all of the products raised by the tenant.[1] A similar example may be found in the state of Washington. In 1897 the supreme court was of the opinion that "while in a strictly etymological sense, it might be that neither the words 'rents, issues, or profits' would embrace the increase of cattle, yet to give this narrow and restricted construction to the statute would lead to results inconsistent with the evident intention of the legislature, which passed the community property law."[2] Profits were therefore taken to include the increase of cattle.

Turning to the realm of higher finance, we find that even there capital may also include profits. For example, in New Jersey profits do not necessarily imply money to be divided. In the words of the court, "they may be represented by the unsold portion of the property which was the subject of the speculation."[3] But the broadest construction given to the capital concept has probably occurred in Iowa. There the court declared:

> Some difference is expressed as to what are profits, and how they are to be arrived at. This is fully answered in *Miller v. Bradish*, 69 Iowa, 278, where it is said: "The assets, resources and funds of the corporation must consist of cash on hand and other property, and, if such assets exceed the liabilities, a dividend can be lawfully declared;" in other words, a profit exists.[4]

It would seem from this decision that if the assets of a business exceed the liabilities by one dollar, then the capital or profits would also equal one dollar—that is, capital and profits would be identical.

That a considerable part of profits, at least, consists of earnings upon capital is a widely accepted theory in American law;

[1] Richmond *v.* Connell (1887) 55 Conn. 403, 11 Atl. 853.

[2] Harris *v.* Van De Vanter (1897) 17 Wash. 489, at p. 492, 50 Pac. 50.

[3] Jones *v.* Davis (1891) 48 N. J. Eq. 493, at p. 499, 21 Atl. 1035.

[4] Hubbard *v.* Weare (1890) 79 Iowa 678, at pp. 688–689, 44 N. W. 915.

it has sifted into our legal decisions from the opinions of English economists and statesmen. Still it is to be noted that such profits are not considered to be the equivalent of interest, but constitute rather the excess income above the expenditures necessary to earn it.[1] Thus in 1883, Lord Selborne construed the profits of a business to be "all the net proceeds of the concern after deducting the necessary outgoings without which those proceeds could not be earned or received."[2] In a similar case two years later, Lord Fitz Gerald adopted a more elaborate interpretation of profits by declaring that the expression means "the incomings of the concern after deducting the expenses of earning them," or "income of whatever character it may be over and above the costs and expenses of receipt and collection."[3] Also, in discussing the general field of profits, jurists have recently shown a marked tendency to avoid primary concepts. This means, of course, in particular states that the entrepreneur's residual incomes are fused into a single profit—the net return above expenses. Thus "divisible profits" are frequently spoken of as the net return which a company, after making all reasonable and adequate provision for its own safety, may properly divide among its stockholders.[4]

It may be frankly acknowledged that in striking contrast to their neglect of the labor theory of profits, American jurists have given great weight to the earning power of capital; so

[1] Bouvier, *loc. cit.*

[2] Mersey Docks *v.* Lucas, *supra*, footnote 3, p. 194, at p. 903.

[3] Last *v.* London Assurance Corp., *supra*, footnote 3, p. 194, at p. 450; see also Dean *v.* Dean (1882) 54 Wis. 23, at p. 33–34; Burt *v.* Rattle (1877) 31 Ohio St. 116, at p. 130; City of Allegheny *v.* Pittsburg etc. R. R. (1897) 179 Pa. 414, at p. 421, 36 Atl. 320.

[4] Bain *v.* Aetna Life Insurance Co. (1891) 21 Ont. Rep. 233, at p. 241; see Bond *v.* Pittard (1838) 3 M. & W. *358, at p. *360; People *v.* Savings Union *supra* footnote 1, p. 187, at p. 203; Braun's Appeal (1884) 105 Pa. 414, at p. 417; Jones *v.* Davidson (1854) 34 Tenn. 447, at p. 452; St. John *v.* Erie Ry. (1872) 21 Fed. Cas. No. 12, 226; Connolly *v.* Davidson (1870) 15 Minn. 519, at p. 530; Eyster *v.* Centennial Board of Finance (1875) 94 U. S. 500; City of Allegheny *v.* Pittsburg etc. R. R., *supra*, footnote 3. The commodity concept of profit really deserves to be treated separately. Portland Bank *v.* Apthorp (1815) 12 Mass. 259, p. 263; Hamilton Co. *v.* Massachusetts (1867) 73 U. S. 632, at p. 640.

much so, indeed, that in many instances—as in the case of manufactured goods—capital profit has been made to absorb the speculative gains of the market. Moreover, little need has existed, except in particular instances, of separating this form of profit from the unearned surplus. In the fields of trade and commerce, however, the direct connection between capital and income is less distinct, the "productivity" of capital is not so apparent, its earning power loses somewhat its usual emphasis, and it is then but a step to the idea that profits are simply the excess of receipts over expenditures. That is to say, American courts, as a whole, are slowly evolving by a process of elimination a pure *value concept* of profit.[1] In fact, though they do not distinguish profit as an unearned increment, they allow, nevertheless, in the solution of practical questions, a surplus value profit that is not a return on labor, capital or land.

IV

In both ancient and modern law land is sometimes designated as capital; and the previous capital concept of profit income, as it has been described, is, therefore, quite similar to the following theory that *land* itself constitutes profits. In a broad sense, objects upon the earth's surface, or anything beneath it, embody in a more or less fixed form such returns to the owner. The right to take timber, ice, stone, minerals or sea weed from a tract of land is equivalent to an interest in the soil and therefore in its profits.[2] Of like nature is the right to use land simply for the purpose of pasturing, fishing or hunting.[3] Where the owner of a farm had allowed another to occupy it without the payment of rent, the single fact that the former had continued to pasture his cattle on the land, and to gather in a legal sense profits with the grass, prevented the

[1] The value concept of profit represents this return as a surplus above the cost of production.

[2] Kennedy Stave etc. Co. *v.* Sloss-Sheffield etc. Co. (1902) 137 Ala. 401, 34 So. 372; Payne *v.* Sheets (1903) 75 Vt. 335, 55 Atl. 656; Hill *v.* Lord (1861) 48 Me. 83, at p. 100; Huff *v.* McCauley (1866) 53 Pa. 206.

[3] Tinicum Fishing Co. *v.* Carter (1869) 461 Pa. 21, at p. 37; Albright *v.* Sussex County etc. Comm. (1904) 74 N. J. L. 303, at p. 305, 59 Atl. 146; Payne *v.* Sheets, *supra*, footnote 2.

tenant from getting exclusive possession against him.[1] Also, the tenant for life is usually entitled to enjoy all the profits of the land during his estate therein. Things to be consumed become his immediate profits; other objects also may be put to the use for which they are especially designed. Possessions which he may use or consume include, of course, all timber, minerals, oil, gas and water on the land; and when his acts are not limited by expressed restrictions, he may in supplying his own needs work the land to the final stage of exhaustion.[2] But in his enjoyment of such concrete profits he is not permitted to damage or waste the estate.[3] Likewise, in other instances, one person may secure a right by grant, inheritance or prescription in the land of another; and his returns therefrom are termed *profits à prendre*.[4]

Where a will has clearly provided for the settlement of debts out of the profits of an estate, the property itself is often sold to meet the requirements of the law.[5] Thus in 1739 an English court explained that the natural meaning of "raising a portion by rents, issues, and profits is by the yearly profits"; but that the word "profits" has, in some particular instances, been extended to include any profits which the land will yield, either by sale or mortgage.[6] But a certain learned judge has

[1] Rennie *v.* Frame (1896) 29 Ont. Rep. 586, at p. 590.

[2] Rankin's Appeal (Pa. 1888) 16 Atl. 82, at p. 87; Koen *v.* Bartlett (1895) 41 W. Va. 559, at p. 567, 23 S. E. 664; Williard *v.* Williard (1867) 56 Pa. 119, at p. 129; Shoemaker's Appeal (1884) 106 Pa. 392; Westmoreland Coal Co.'s Appeal (1877) 85 Pa. 334; Kier *v.* Peterson (1861) 41 Pa. 357, at p. 361; Neel *v.* Neel (1852) 19 Pa. 323, at pp. 327–328; Holman's Appeal (1854) 24 Pa. 174, at p. 178; Wentz' Appeal (1884) 106 Pa. 301, at p. 307; McClintock *v.* Dana (1884) 106 Pa. 386, at p. 391.

[3] Smith *v.* City Council of Rome (1855) 19 Ga. 89, at p. 92; Dickinson *v.* Jones (1867) 36 Ga. 97, at p. 104; Co. Lit. 54b.

[4] Payne *v.* Sheets, *supra*, footnote 2, p. 198, at p. 344; Kennedy Stave etc. Co. *v.* Sloss Sheffield etc. Co., *supra*, footnote 2, p. 198; Albright *v.* Sussex County etc. Comm., *supra*, footnote 3, p. 198; Wickham *v.* Hawker (1840) 7 M. & W. 62, at p. 79; Ewart *v.* Graham (1859) 7 H. L. C. *331; Post *v.* Pearsall (N. Y. 1839) 22 Wend. 425, at p. 441; Cobb *v.* Davenport (1869) 32 N. J. L. 369, at p. 384; Bingham *v.* Salene (1883) 15 Ore. 208, 14 Pac. 523.

[5] *Ex parte* Artis (1752) 2 Ves. 490; Anonymous (1682) 1 Vern. 104; Lingon *v.* Foley (1675) 2 Ch. Cas. 205.

[6] Ivy *v.* Gilbert, *supra*, footnote 1, p. 194, at p. 19; Trafford *v.* Ashton (1718) 1

stated that there is not one case in ten in which the court has decreed a sale on the words "rents and profits" that it was in harmony with the testator's intentions. Yet to aid a creditor, as he has explained, a sale has often been ordered on the ground that "rents and profits" in a will mean to pass the land.[1] The general rule in England seems to be that the natural meaning of the word "profits" in this connection is "annual profits," but it should be noted that where the court is not expressly confined to this intrepretation, it is construed in its broadest sense to constitute the land itself.[2]

V

Although American courts do not definitely emphasize the *value concept* of profit as a surplus above the costs of production, it seems, nevertheless, that in the case of speculative ventures and monopolized industries, this view has found its proper niche in the general plan of legal profits. Indeed, a pure value surplus in speculative enterprises has been accepted as legitimate profit in English law since the middle of the seventeenth century; and the clear-cut opinions of these early decisions have been followed in a greater or less degree in our own states. In some respects our state decisions go even farther than the English law; and as economists we are interested here especially in two sets of cases. In the first group, the value surplus is uniformly considered to be profits; in the second, it is un-

P. Wms. 415, at p. 418; see Evelyn *v.* Evelyn (1731) 2. P. Wms. 659, at p. 666; Mits *v.* Banks (1724) 3 P. Wms. 1, at p. 8; Okeden *v.* Okeden (1738) 1 Atk. 550; Small *v.* Wing (1762) 3 Bro. P. C. 503; Gibson *v.* Rogers (1750) 1 Amb. 93, at p. 95.

[1] Baines *v.* Dixon (1747) 1 Ves. 41, at p. 42; see also Green *v.* Belchier (1737) 1 Atk. 505, at p. 506; Reed *v.* Reed (1812) 9 Mass. 372; Goldin *v.* Lakeman (1831) 2 B. & Ald. 30, at p. 42; Fox *v.* Phelps (N. Y. 1837) 17 Wend. 393; Earle *v.* Rowe, *supra*, footnote 2, p. 187.

[2] Whether or not the land is sold depends upon the general terms of the will, the time allowed for raising the necessary funds, the situation of the estate, the nature of the debt and the age of the beneficiaries. Barnardiston *v.* Carter (1717) 3 Bro. P. C. 64; Heneage *v.* Lord Andover (1829) 3 Y. & J. 360; Gore *v.* Gore (1722) 2 P. Wms. 28, at p. 63; Albemarle *v.* Roger (1794) 2 Ves. Jr. 477, at p. 483; Earl of Pomfert *v.* Lord Windsor (1752) 2 Ves. *472, at p. 480. Ivy *v.* Gilbert, *supra*, footnote 1, p. 194.

hesitatingly declared to be capital. In this second instance, the courts are apparently undertaking the important task of separating the pure value increment from what appears to them to be the actual or concrete income of an estate.

This concept of profit is, in the first place, readily found in cases which relate to speculation in real estate. As early as 1859 a court in Ontario recognized that the scarcity surplus from a speculative enterprise is a substantial profit. The profits here were to be divided equally between two partners, one of whom furnished the capital while the other selected and purchased desirable tracts of land. It was not clear to the court whether there were actual profits from the sale of the land, or only estimated returns based on its valuation. It was nevertheless held that the profit to be divided equally between "the parties was the value, whether ascertained upon resale or by valuation, after deducting the cost and incidental expenses."[1] In a later case in Missouri, which involved two firms engaged in the real-estate business, each party to the contract in question was entitled to one-half of the "acquisitions beyond expenditures." Citing Webster's Dictionary as authority, the court decided that this expression was a definition of profits, and that in the contract it represented the land as well as the money obtained by the firms from their various deals.[2] Again, in referring to an investment in wild or unproductive land, the court of Pennsylvania in 1890 expressed the opinion that if the sum for which the speculator sells it "does not exceed the purchase money and interest thereon, he does not realize a profit on the investment."[3] That is, while the courts of this state seldom include interest in profits, they frequently recognize the speculative increment as such.

In other decisions this idea of profit is not so readily accepted. Thus in the early cases of this same state, which determined the right of the life tenant to the profits of an estate held in trust for the beneficiaries of a will, the pure value sur-

[1] Proudfoot v. Bush (Upper Can. 1859) 7 Grant 518, at pp. 522–533.

[2] Carter v. Arnold (1896) 134 Mo. 195, at p. 208, 35 S. W. 584.

[3] Hentz v. Pennsylvania Co. (1890) 134 Pa. 343, at p. 347, 19 Atl. 685.

plus of property was considered to be profits; [1] but in a recent case the ground has been taken that such increased value is capital and passes with the estate.[2] In deciding the same issue, the courts of New York also follow the principle that the right of a life tenant to the profits of an estate does not include the surplus arising simply from an increase in its value.[3] But in many decisions the subject matter is so complex that there seems to be no settled definition of profit, and the value increment is often designated as either capital or profits. Thus in 1895 it is conceded by one court of this state that both the speculative increment and interest may sometimes be included in profit. "And while the interest or income as well as increased value of the securities," runs the opinion, "may be treated as profit, that term in common parlance is the pecuniary advantage resulting from dealing or trafficking in property." [4] Almost ten years later a much better definition is included in the opinion of another court of this state. After repeating the prevailing formula that "profit" ordinarily means the excess of returns over expenditures, it "may or may not, according to circumstances," declared the court, "include in the returns any increase in value of the capital, and in the expenditures any depreciation of capital." Lastly, in a more scientific sense, it is said to be the excess which remains after deducting from the returns, not only "the operating expenses and depreciation of capital, but also interest on the capital employed." [5] The opinions of these last two states represent the most advanced analysis of profits. At least most courts seem to follow no one established rule in determining the entrepreneur's income.

The value concept is also intrenched securely in a large group of decisions involving the collection of profits which have been

[1] Earp's Appeal (1857) 28 Pa. 368, at p. 374; Smith's Estate (1891) 140 Pa. 344, at p. 352; 21 Atl. 438.

[2] Hubley's Estate (Pa. 1884) 16 Phila. 327, at p. 330; Graham's Estate (1901) 198 Pa. 216, at pp. 220–221, 47 Atl. 1108; Kemble's Estate (1902) 201 Pa. 523, at p. 525; 51 Atl. 310.

[3] Matter of Proctor (1895) 85 Hun. 572, 33 N. Y. Supp. 196.

[4] *Ibid.*, at p. 573.

[5] Mayer *v.* Nethersole (1902) 71 App. Div. 383, at p. 388, 75 N. Y. Supp. 987.

lost by the nonperformance of a contract. If one party in purchasing commodities or services fails to keep his agreement, the second may suffer two important losses which consist of (a) the expenditures made before the contract was broken, and (b) the prospective profits. It will be noticed that the second item comprises solely future profits—that is, a surplus value over expenses, which may be collected as damages, though it may be entirely unearned. If the claimant cannot furnish direct proof of his ability to secure such prospective returns during the performance of his agreement, or if they are highly speculative in character, they will not be allowed as damages. By this ruling highly speculative gains are eliminated from such contingent profits. But in some instances profits are so certain that they become part and parcel of the contract itself. For example, if one person has agreed to furnish certain goods to another on a particular day at a definite price, but fails to perform his part of the contract, the second person may usually collect the difference between the stipulated price and the market value of the commodities at the time they should have been delivered. It is obvious that the second person has never really earned this profit, but the speculative income becomes none the less a legitimate return.[1] In like manner, if one person has contracted for definite services, or for the delivery of certain goods at a specified time, and refuses subsequently to keep his agreement, he is usually liable in damages for the difference between the expenses incurred by the plaintiff and what the latter would have received had he been permitted to complete his contract. The Supreme Court of the United States follows a definite rule in estimating the profits to which the plaintiff is entitled in such cases. Damages shall consist of "the difference between the cost of doing the work and what claimants were to receive for it, making reasonable deduction for the less time engaged, and for release from the care, trouble,

[1] Grainsford *v.* Carroll (1824) 2 Barn. & Cress. 624; Clark *v.* Pinney (N. Y. 1827) 7 Cowen 681; Quarles *v.* George (1839) 40 Mass. 400; Shepherd *v.* Hampton (1818) 16 U. S. 200, at p. 204; Dey *v.* Dox (N. Y. 1832) 9 Wend. 129, at p. 134; Shaw *v.* Nudd (1828) 25 Mass. 9, at pp. 13–14; Leigh *v.* Patterson (1818) 8 Taunt. 540.

risk, and responsibility attending a full execution of the contract."[1] To be more explicit, the entrepreneur usually makes two forms of expenditures, namely money and personal sacrifice. But as he does not undergo this personal sacrifice in this particular instance in performing his part of the contract, he is only entitled to compensation for his actual losses and to the surplus value which he would have acquired had he been allowed to complete his agreement. Profits of this sort have been collected from the United States because of its failure to carry out its contract in securing supplies for the army; but in repairing the harbor at New Orleans, although the government again failed in its agreement, the entrepreneur was unable to show convincing proof that his profits would have consisted of other than speculative returns.[2]

In still a third set of cases wholly speculative profits may be recovered if companies in which they are properly insured refuse to pay them. The right in England and the United States to insure expected, contingent or speculative profits has been settled by a long line of rulings which refer usually to losses at sea. This general expectation of profit is a definite entity, susceptible of possessing value and of being sold; it is sometimes insured entirely independent of the value of the cargo, but the latter must be known to determine the actual profits had the merchandise been sold.[3] English courts usually require the owner of the cargo to show that a definite profit would have been realized from the adventure if the property had not been lost.[4] He is not allowed to collect imaginary

[1] United States *v.* Speed (1868) 75 U. S. 77, at pp. 84–85.

[2] *Ibid.*, United States *v.* Behan (1884) 110 U. S. 338, at p. 345, 4 Sup. Ct. 81; see Hinchley *v.* Pittsburg Steel Co. (1887) 121 U. S. 264, at pp. 276–277, 7 Sup. Ct. 875; Masterson *v.* Mayor etc. of Brooklyn (N. Y. 1845) 7 Hill 74; Philadelphia etc. R. R. *v.* Howard (1851) 54 U. S. 307, at p. 344; Fox *v.* Harding (1851) 61 Mass. 516; Hawley *v.* Corey (1893) 9 Utah 175, 33 Pac. 695; Dr. Harter etc. Co. *v.* Hopkins (1892) 83 Wis. 309, 5 N. W. 501.

[3] Abbott *v.* Sebor (N. Y. 1802) 3 Johns. Cas. *39; Halhead *v.* Young (1856) 6 El. & Bl. 312; M'Swiney *v.* Royal Exchange Assurance (1849) 14 Q. B. 634.

[4] Hodgson *v.* Glover (1805) 6 East 316; Lewis *v.* Rucker (1761) 2 Burr. 1167; Barclay *v.* Cousins (1802) 2 East 544; Eyre *v.* Glover (1813) 16 East *218, at p *220; Grant *v.* Parkinson (1781) 3 Dang. 16; see Ionides *v.* Pender (1872) 27 L T. R. 244.

profits or insure the returns of a mere wager.[1] In the United States, on the other hand, the owner of the insured merchandise is not required to furnish this form of proof. In a New York case, Mr. Justice Livingston was positive that "it does not follow that a profit will be made if the cargo arrives: yet its loss would give a right to recover on such an insurance."[2] It has also been held by a court of the United States that the insured profits on a ship and cargo lost at sea were recoverable without showing that there would have been an ultimate profit if the loss had not occurred.[3] Contrasted in other words, the English law does not allow the owner of a cargo to shift market risks upon the insurance company—the latter takes only the risks of the sea; but the law of our own states allows the underwriter to accept both hazards. Certain it is, that in either case a profit consisting entirely of an unearned value or a scarcity surplus may be reaped on such speculative ventures not unlike the gains of the stock market. That is to say, this form of profit is simply "the improved value of the cargo when it has been landed at its destined port;"[4] and, as it may be fully insured against all perils of the sea,[5] it is plain that the entrepreneur takes only market risks. Yet this form of insurance has been properly legalized by favorable decisions.[6]

It is clear from the preceding discussion that while American jurists have recognized a pure surplus-value income, they have not gone far from the idea that profit is a concrete product of land, labor or capital. For example, the land itself, its contents and the chattels upon it are still considered as profits in modern decisions. Moreover, the theory that the concrete return of the land in the form of soil, minerals, fish and game

[1] Stat. 19 Geo. II, c. 37.

[2] Momford *v.* Hallett (N. Y. 1806) 1 Johns. *433, at p. *438.

[3] Patapsco Insurançe Co. *v.* Coulter (1830) 28 U. S. *222.

[4] Halhead *v.* Young, *supra*, footnote 3, p. 204, at p. 324.

[5] Royal Exchange Assurance *v.* M'Swiney (1850). 14 Q. B. 646, at p. 660.

[6] Barclay *v.* Cousin, *supra*, footnote 4, p. 204, at p. 548; Craufurd *v.* Hunter (1798) 8 Durn. & E. 13; Lovatt *v.* Hamilton (1839) 5 M. & W. *639; King *v.* Glover (1806) 2 Pos. & Pul. N. R. 206; Flint *v.* Flemyng (1830) 1 B. & Ad. 45, at p. 48.

is a profit in kind is a doctrine not far different from the legal rent concept; for rent may likewise be paid in land, products or money. In these cases, rent rests, therefore, wholly upon a productivity concept of the profit from land; it still issues out of the land or is paid out of the profits from it. Also tenements, as distinguished from the stock or chattels on leased premises, are still attached to the land, and rent issues from them as a matter of course. From the stock, however, only profits and interest are obtained, yet as an exception to this rule the courts in Virginia and Pennsylvania have also attached the rent concept to such chattels. These productivity concepts are a direct inheritance from certain leading cases of the medieval period. Their importance to-day is doubtless largely due to the conservative character of the law. But in reviewing the complex and trying questions which appear before American courts, one is fully impressed by the constant use which is still made of these concepts and the apparent need for their retention.

However, there is a tendency in some states to unite rents, profits, and interest into one income. As a New York court concluded:

> In fine, whatever this business continuously earned as rent or profits or interest or income or profit, is contemplated and described by the words "profits and gains" and "income" used by the testator, for rent is a profit, and profit is a gain; interest is a profit or income; income is a gain or a profit, and profit is a gain, and, generally, whatever is received for the hire or for the use of property is a gain.[1]

In rendering this decision the court left out only the labor and risk concepts of profit—an exception which was probably due to the fact that they were not relevant to a decision of the issue. This excerpt is a timely illustration of the flexibility of the common law and of the use of terms, which preserve so effectively the original profit concepts of medieval decisions. Of course, no real harm is done in recognizing that profits are paid out of land, capital, products or money; but great danger does lie in attributing to these elements the primary cause of

[1] Thorn *v.* De Breteuil, *supra*, footnote 4, p. 194, at p. 417.

profits. By conceding to capital, labor, and land only their respective parts, we may more easily accomplish a much-needed analysis of the surplus increment which goes to the entrepreneur. But having discounted the effect of these factors upon production, the legalists are obviously puzzled over the exact nature of the surplus which remains after deducting interest and wages of management. This increment is being slowly analyzed and differentiated into its numerous elements; and only recently courts have realized its complex character.

Looking over the whole varied range of legal concepts of profit we may draw several pertinent conclusions:

First, although our courts have more or less discarded the labor concept of profit, except in suits for damages, there still remains sufficient legal authority for an efficiency theory of profits. That is, if we define efficiency profits as the gain arising from reduced costs of production, there are many decisions which in their general context would support this new concept of profit. As recent evolutions in industry have forced upon them new impressions of the magnitude of the residual surplus, less attention has been given to the labor and capital concepts of profit. In several decisions, indeed, it is denied that profits constitute a compensation for the use of capital; in other opinions it is likewise denied that profits form the real compensation of labor. That profits depend on the peculiar powers of both capital and labor, without being exactly a compensation for their services, is doubtless the view of many American judges. As we have observed, this surplus is commented upon in Bouvier's *Law Dictionary*. It is said there, in referring to the views of the classical economists, that gross profits equal the difference between the value of advances and the value of returns, that the net profit constitutes so much of this difference as may be due solely to the capital employed, and that "the remainder of the difference, or, in other words, the gross profits minus the net profits, has no particular name, but it represents the profits attributable to industry, skill and enterprise."[1] Again, in that branch of the law which controls the

[1] Bouvier, *loc. cit.*

A DIVISION AMONG THEORISTS IN THEIR ANALYSIS OF PROFITS

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A DIVISION AMONG THEORISTS IN THEIR ANALYSIS OF PROFITS

SUMMARY

The classical economists regarded minimum profits as an element in cost of production, 115. — Walker's rent theory, 118. — Similar views by other Americans, 119. — By Europeans, 121. — Profits regarded as wages of labor by still others, 123. — Distinction needed between earned efficiency profits and unearned scarcity profits, 127. — Efficiency profits recognized by the law, 128. — Patents, trade secrets, invention, 129. — Judgment and risk-taking, 133. — Surplus or scarcity profits differ from efficiency profits, 134. — Are not an element of cost, 135. — Defects of the labor theory, 136.

AMONG the various theories which attempt to explain the origin of profits, a small number still occupy secure positions in economic thought. The risk concept is familiar to all advanced students of economics; and the surplus theory of profit, as an excess above cost of production, constitutes an almost indispensable part of any thoro discussion of the entrepreneur's income. At the same time, the rent theory of profits, which explains the origin of this income as a mere differential return above a no-profit margin, has done much to emphasize the similarities between all shares in production. Finally, the labor theory by a simple method represents the entrepreneur's residual returns as massed into a single, but complex product, with many peculiarities. Other doctrines, of minor importance, present a variety of views which run the entire gamut of notions from the surplus concept, on the one side, to the labor theory on the other; and it is, therefore, plain that in tracing the irreconcilable division between the devotees of these

last two theories, the description finally given here of a pure efficiency profit,[1] derived from a reduction of costs, does not break entirely with the traditions of economic science.

The classical economists seldom failed to maintain that profits entered into the cost of production. Adam Smith's explanation of the nature and source of such returns was ultimately based, it is true, on the productivity of labor. Nevertheless, profits were regarded as really a payment for the risk taken and the services performed by the entrepreneur in production.[2] David Ricardo, however, did not consider profits to be a deduction from wages, but a surplus above the return of labor, which compensated the employer for the usual risk and trouble encountered in employing capital productively; and as such they were regarded as forming necessary costs of production.[3] "Mr. Malthus appears to think," said Ricardo in reply to that writer, "that it is a part of my doctrine, that the cost and value of a thing should be the same — it is, if he means by cost, 'cost of production' including profits."[4] Fortunately, this statement has set at rest any doubt as to Ricardo's classification of profits; and without this, the interpretation of the younger Mill would be less clear. The latter adopted in particular the point of view of Adam Smith that "The cause of profit is that labour produces more than is required for its support." In this respect Mill is plain: "If the labourers of the country, collectively, produce 20 per cent more than their wages, profits will be 20 per cent, whatever prices may or may not be."[5] But Mill,

[1] For a description of this theory see the American Economic Review for June, 1918.

[2] Smith, Wealth of Nations, Bk. I, chap. vi, pp. 50, 56.

[3] Ricardo, Principles of Political Economy, ch. iv, section 33, p. 68; sections 43, 44, pp. 97, 99, 101.

[4] Ibid., section 6, p. 39, note.

[5] J. S. Mill, Political Economy, Bk. II, chap. xv, section 5.

like Ricardo, appreciated the importance of the entrepreneur's sacrifices and, therefore, represented the risk-taking function as in a large measure the basis of a minimum profit — an adequate compensation for "some additional risk" over that incurred upon idle capital.[1]

By all three writers, profits were treated as essentially a cost element in the necessary or natural price of a commodity. To Smith, a minimum profit was the lowest ordinary profit, which "must always be something more than what is sufficient to compensate the occasional losses to which every employer of stock is exposed."[2] And Mill's "minimum rate of profit," by including interest and insurance against risk, resembles very closely Smith's "lowest ordinary rate of profit." Mill separates gross profits into interest, wages of superintendence, and compensation for risk;[3] but these also constitute a minimum profit which he treats as a part of necessary price: "The cost of production, together with the ordinary profit," says Mill, "may therefore be called the *necessary* price, or value of all things made by labor and capital."[4] But where commodities can be made in indefinite quantities, this ordinary profit, or "this necessary value, the minimum with which the producer will be content, is also, if competition is free and active, the maximum which they can expect." Now, as in the general trend of his discussion, Mill makes cost of production equivalent to "necessary price," it is but logical that minimum profit should be regarded as a constituent part of the cost of production. Here again, Mill was building on the work of Smith[5]

[1] J. S. Mill, Principles of Political Economy, Bk. IV, chap. iv, section 3, p. 441; see also Bk. II, chap. xv, section 2.

[2] Wealth of Nations, Bk. I, chap. ix, pp. 75, 76.

[3] Principles of Political Economy, Bk. II, chap. xv, sections 1, 2.

[4] Ibid., Bk. III, chap. iii, section 1.

[5] Wealth of Nations, chap. vii.

and Ricardo,[1] who had already established the concept of a natural price. And Mill has acknowledged that "Adam Smith and Ricardo have called that value of a thing which is proportioned to its cost of production, its Natural Value (or its Natural Price). They meant by this, the point about which the value oscillates, and to which it always tends to return."[2]

Altho the English writers of this period differed widely in their views of the origin of profit, our interest lies chiefly in the fact that Smith, Ricardo, and J. S. Mill were firm in their belief that minimum profits, at least, entered into natural price as a cost of production. By all three, profits were regarded as a surplus to which the employer was entitled because of the trouble, risk, abstinence, labor of inspection or expense, which he assumed in the process of production.[3] At the time when these men wrote, the right of contract was not so fully developed and there was less restraint upon trade than there is today. In the absence of complex industrial conditions, these economists were able to determine the exact location of the normal competitive plane which forms the natural dividing line between efficiency profits, on the one side, and scarcity surpluses including inchoate rent on the other. At least, to them profits were a part of the cost of production, rent a surplus above it. Of great pertinency is this fact to any present theory of profits.[4] From this simple idea of a normal

[1] Political Economy, chap. iv, pp. 65, 69; chap. vi, p. 97.

[2] Moreover, this normal value was supposed to make its appearance under a state of stable equilibrium; for the chapter is closed in these words: "but the condition of *stable* equilibrium is when things exchange for each other according to their cost of production, or, in the expression we have used, when things are at their Natural Value." Ibid., Bk. III, chap. iii, section 2.

[3] Smith, Wealth of Nations, Bk. I, chap. vi, p. 24; Bk. I, chap. x, pp. 50, 51; Ricardo, Principles of Political Economy (Gonner's ed.), pp. 68, 97, 101; Mill, Political Economy, Bk. II, chap. xv, sections 1, 2; Essays, pp. 107, 108.

[4] See also Cairnes, Some Leading Principles of Political Economy, chap. iii, section 3; Bagehot, Economic Studies, p. 197; Rogers, Political Economy, p. 139.

competitive line, which included profits in costs of production, have run many divergent views; but in assuming the task of unraveling this tangled web of economic theory, we shall always bear in mind the location of this point of normal value.

President Walker was one of the first of the surplus theorists to divert attention from this classical theory of a minimum profit; and it was exactly at the point of normal value, or natural price, that he constructed his first serious change in the established profit theory. Stated concisely, this noted writer expressly rejects the idea of a minimum profit as a cost of production at the margin. By presenting the important concept of a price-determining no-profit margin for which all profits are measured as differentials, he laid the foundation for endless confusion among economists. This no-profit margin forms the pivot upon which his theory of distribution turns. From it upwards in constantly increasing sums, the entrepreneur's returns finally amount to tremendous proportions. Consequently, this startling innovation led to the logical conclusion that profits are practically of the nature of rent, and not a part of the cost of production. Precisely as land rent is represented as a price-determined increment above costs, so the entrepreneur's profits are described as surpluses measured from the price-determining margin of production.[1] And, therefore, such profits would, under full and free competition, not form a part of the price of commodities, and are not obtained by a deduction from wages It is plainly apparent that Walker's theory of profits closely resembles the classical concept of rent; and that he has extended it until it comprehends what he might have termed "efficiency profits."[2] Doubtless this theory

[1] Political Economy, pp. 239, 250.

[2] The Wage Question, pp. 230, 245.

affected somewhat the thought of other economists. Especially may we call attention to the views of President Andrews, who expressly rejected risk as a "reason of profits," and preferred what he has designated as a nomenclature,—"taking pure profits, or profits proper, as the remuneration of special original talent exercised in any industrial direction." Altho this gain, except in the case of monopoly, as he explains, "is brought about solely by better management than the poorest which still continues," he concedes Walker's argument, nevertheless, by saying that pure profits are governed by a law analogous to rent and that "neither enters into the price of products, nor lowers or any wise antagonizes wages." Finally, he differentiates gains of opportunity due simply to mere chance from what he calls profits of opportunity in trade "created by natural ability functioning in purely economic ways." That is, profits, as he has described them, are said to vary mainly with ability, partly with opportunity.[1] While Walker's method of exposition is full and elaborate and his ideas are clearly expressed, the smaller work left to us by President Andrews is very compact, the thought is somewhat condensed, and his meaning is not always easily deciphered. Yet it is none the less plain that these two authors were not far apart in their conception of a rent theory of profits.

That this surplus concept of profits has become firmly rooted in American economic theory may be drawn from various excerpts. In a recent book of a widely known author, "profits are a result of fluctuations in market value and would not exist in a state of normal equilibrium." And under the same conditions, "Gross profits must include interest and wages. But there would be no net profits, or surplus profits, or profits in

[1] E. B. Andrews, Institutes of Economics, pp. 186–189.

the real sense of the word." Certain it is that Professor Seligman does not give recognition in his text-book to those profits of efficiency which arise solely from reduced costs of production and do not disappear in a normal state of equilibrium.[1] Quite in agreement with this view of Seligman's is an excerpt from Seager's text: "As the above analysis suggests, profits which are not monopoly profits are soon overtaken and eliminated by competition. If improvements were to cease profits from this source would soon cease also."[2] In this group may also be included Professor J. B. Clark, whose statement in relation to profits is very similar: "In actual business, competition is often sharp enough to prevent men from getting more than interest on their capital and a fair return for the labor they spend in directing their business; and pure theory here assumes that competition is always and everywhere sharp enough to do this."[3] In a somewhat similar vein runs the conclusion of Professor Patten: "The profits of which mention has been made are those of falling prices due to improved processes. When improvements cease, these also cease."[4] A. S. Johnson has made a rough but useful distinction between the surplus concept of profits and profits in the business sense of the term: "A surplus remains in the hands of the enterpriser after all costs have been met. This surplus is known in economics as 'pure profits,' or more simply as 'profit.' We must be careful to distinguish profit in this sense of the term from the income known as profit in the language of business. In the latter sense profit often includes interest on the enterpriser's capital and wages for his

[1] Seligman, Principles of Economics, pp. 353, 354.

[2] Seager, Introduction to Economics, p. 182.

[3] Essentials of Economic Theory, p. 87, see also pp. 116–119; Political Science Quarterly, vol. ii, p. 610.

[4] Patten, Theory of Prosperity, pp. 126, 127.

labor. Profit in the economic sense of the term is not essential to the continued operation of an established enterprise. Profit in the business sense of the term is a necessary income, since no one would remain long in a business unless he obtained a return representing interest on his capital and wages for his labor." [1] Needless to say, the modern concept of a surplus profit maintained in the respective works of these various authors is a distinct and most important departure from that contained in the writings of the classical economists. There is no more interesting contribution to modern economic theory than this peculiar residual concept of profit. It is founded upon their conception of the present dynamic state of industry; and the obvious harvest of great unearned surpluses at the present day goes far in stressing their point of view. Clear it is, that their contribution to economics is a most timely one.

Nor is this evolution of a surplus profit theory confined to American writers. It has been pointed out by Gide that " Professor Walras employs a formula which at first seems astounding, when he declared that *the normal rate of profit is zero.* By this statement he means that upon the supposition of absolutely free competition the price which the entrepreneur pays for productive services (including his own) must necessarily be equal to the price for which he sells the finished product; profits must therefore be equal to zero." [2] Gide himself, in an early text, states postively that competition cannot eliminate profits " by lowering the price of articles to the level of the cost of production, for in that case the employer would make no gains, and would cease to produce." Between the cost of production and the selling price, Gide allows a margin which represents minimum

[1] Johnson, Introduction to Economics, p. 238.

[2] Gide, Principles of Political Economy, p. 632, note.

profits in the form of producer's interest, insurance against risk, and wages for the employer's labor. However, in a later edition, this writer presents a more comprehensive analysis of the entrepreneur's functions and, after including such returns in the costs of production, accepts, almost unqualifiedly the surplus concept of profits. Profits as a surplus are possible, it is said, only when the entrepreneur is in possession of some sort of monopoly — "that is to say, if the entrepreneur brings nothing on the market except what anybody else can offer, there is no profit." [1] Finally, in the native land of the classical economists has appeared the most marked violation of the orthodox doctrine; for English authors are not wholly unanimous in their devotion to the labor concept of profit. The rapid strides of the present industrial evolution, the sudden dynamic changes of society and the appearance of fabulous profits have had their influence on even the most conservative writers. We may select a particular example. By making the entrepreneur an idle speculator in town sites, Professor Nicholson has extended the sphere of profits until it clearly includes land rent: [2] "A speculator who has the good luck (for, in general, there is more luck than skill) to hit upon the site of a future town has simply to sit still." It need hardly be repeated that these various views make profits analogous to the now familiar unearned scarcity increment. This phase of profits is not emphasized in the writings of the English classical school; but modern problems have forced it upon us and have served to stress the importance of this modern tendency in economic thought.

It would be strange, indeed, if so many recent writers had erred in the explanation of profits. The fact is, each

[1] Gide, Principles of Political Economy, compare pp. 483–485, ed. 1896, with pp. 630–632, ed. 1904.

[2] Political Economy, vol. i, p. 400.

is correct from his point of view; there is an element of truth as he sees it. A diversified entrepreneur's income has permitted careful investigation from widely divergent angles and has allowed emphasis to be placed upon totally different phases of so-called profits. The crudest analysis reveals the existence of a scarcity surplus above costs, which truly enough will be gradually eliminated by competition; and which will, of course, tend to disappear in a static state of equilibrium. There is probably no disagreement among economists on this point, for most writers will probably concede that a pure value surplus is truly an unearned increment. The surplus theory of profits, however, in the hands of certain writers, has gradually assimilated all residual incomes of the entrepreneur, except mere wages of management — the whole thus represented is said to form a market surplus which does not enter into costs.

On the other hand, the surplus concept of profit runs counter to the views of a large group of economists, and it is evident to numerous writers that the entrepreneur's personal disutilities resemble very closely the laborer's sacrifices. The undertaker is, therefore, allowed as profits little more than a substantial and somewhat liberal wage of superintendence which is conceded to be a cost in production, tho it is not always clear that this cost is price determining. Thus, in Bullock's text, the entrepreneur is "an organizer and independent manager of business," whose returns are necessary and differential profits. All entrepreneurs receive necessary profits which "include interest on invested capital," besides "the remuneration for the efforts and trouble that employers incur in the management of productive enterprises." The last element — "wages of superintendence, resemble the wages of labor." [1] Likewise in

[1] Introduction to Economics, pp. 424, 526; 3d ed., pp. 460, 462.

speaking of profits Professor Fetter has said: "They are not subtracted from the gains of labor but are earned, in the same sense in which the wages of skilled labor are earned. So long as some men have better organizing ability than others, have better judgment, are better able to take the risks, there is reason to believe that profits will continue."[1] In like manner, Professor Ely adds "wages of management," at least, to the cost of production. Also, "minimum profits are necessary profits, the profits needed to induce the entrepreneur to continue his productive work. In many cases they can be measured roughly by the salary which the entrepreneur could get by working for some one else."[2] Particular functions and costs of the entrepreneur have been presented in a very concise form by Professor F. M. Taylor, who finally concludes that the sacrifice or disutility of assuming the responsibility of production necessarily forms a class by itself. According to this analysis, the entrepreneur's costs classify as follows: "(1) Actual outlay of the entrepreneur. (*a*) Money costs. (2) Expression in money of the entrepreneur's contributions, in so far as they are purchasable. (*b*) Real cost or sacrifice of assuming ultimate responsibility — this having its objective expression in money profits."[3] In comparison with the preceding views this is a liberal interpretation of the labor function. Certain it is, that these economists are on safe and conservative ground in affirming that costs include mere wages of routine management. But it is to be observed that this labor theory, in its broadest aspect, extends "wages of superintendence" to the entire legitimate profit income of the entrepreneur — a scope formerly given to profits probably by the English school and

[1] Principles of Economics, p. 291.
[2] Outlines of Economics, pp. 440, 441.
[3] Principles of Economics, p. 52.

carefully redefined and elaborated in several recent works.

Consequently, to the more radical followers of this labor theory, all profits, after being purged of grossly illegitimate gains, are merged into one share — a labor income. An eminent English economist, Professor Marshall, while devoting considerable space to a discussion of the subject of profits, speaks thus of the entrepreneur's income: "All his prospective gains enter into the profits which draw him towards the undertaking; all the investments of his capital and energies in making the appliances for future production, and in building up the immaterial capital of a business connection, have to show themselves to him as likely to be profitable, before he will enter on them; the whole of the profits which he expects from them enter into the reward, which he expects in the long run for his venture. . . . Thus the whole of the normal profits enter into true or long-period supply price." [1] And finally, in the recent text of Professor Taussig may be found, perhaps, the clearest and most concise statement of this point of view: "Whether the term 'business profits' should be thus limited is primarily a question of phraseology. The emphasis which this view puts on the relation between improvements and the business man's gains is just. The large and conspicuous gains are in fact associated almost invariably with advances in the arts, with boldness and sagacity in exploiting new enterprises and new methods. None the less, this mode of sharply separating business profits from wages seems artificial. Even the routine conduct of established industries calls for judgment and administrative capacity, and so for the exercise of the same faculties that are more conspicuous of rapid progress. To separate even roughly the earn-

[1] Principles of Economics, 5th ed., pp. 617, 618.

ings of a successful business man into two parts — one wages, the other 'profits' in the sense of gains from progress — would seem to be quite impracticable. Looking over the whole varied range of earnings among those engaged in the business career, it is simplest to regard them all as returns for labor — returns marked by many peculiarities, among which the most striking are the risks and uncertainties, the wide range, and high gains from able pioneering."[1] Thus have Marshall and Taussig placed themselves on record in remarkable opinions — notable for their thoro adherence to the original profit concept of the classical economists and for their rejection of the surplus concept of recent theory; for in the works of both of these men, efficiency profits, tho often described as great prizes which go to the skilled, daring and alert, are never separated entirely from the labor income.[2]

Doubtless every one of the preceding profit theories occupies, in a restricted sense, its appropriate niche in economic thought; but if careful consideration is given to the foregoing excerpts, it soon become obvious that the more radical representatives of both the surplus and labor theorists have assumed in their premises more than is scientifically sound, and in their conclusions more than has really been verified. In either case, the primary steps in their analysis are not conclusive; and, above all, both theories by overlaping include in their scope wholly unlike elements. To be more exact, large returns arise from the profits of efficiency which are due solely to new ideas and reduced costs in the process of production. These incomes are the rewards of dynamic efficiency and risk-taking rather than of labor; and,

[1] Principles of Economics, vol. ii, p. 185.

[2] This tendency to view profits either as largely temporary and unearned or as mostly permanent and earned may also be seen in the discussion of risk profits — a topic to be treated in a separate article.

moreover, they are not eliminated by competition, even in the static state. That is, exercising absolute control over the destiny of capital, inventing new ideas, and taking risks are not considered here as primarily a part of the labor function. Plainly stated, these writers have failed to analyze properly the various incomes of the modern enterpriser; and their works do not show due appreciation of conditions as they actually exist. They see at one time only one side of the tremendous, but most alluring, profit-making function. In fine, neither of these theories differentiates the returns of intra-marginal producers; and strange enough, no attempt is made to separate the profits of efficiency from the fluctuating market surplus.

In marked contrast to both the surplus and the labor theories, a division of the entrepreneur's residual surplus into both earned and unearned increments, permits a much desired scientific classification of profits. Let us say, first, that the entrepreneur receives an earned income because of his peculiar dynamic efficiency in controlling the destiny of capital, in incorporating ideas into industry and in assuming all risks in connection with them. This function serves in particular instances to reduce outlays and is borne solely by the entrepreneur. We would first separate here efficiency profits, under freely competitive conditions, by making them equivalent to the net output measured by the reduction of costs to the entrepreneur. Or, if one prefers to use another method, the net output may be valued in the costs of the same quality of product on the extensive margin. In the second place, all unearned profits may, as a rule, be distinguished as various forms of the scarcity increment, which arise from an increased intensity of demand forces. Whether such profits are due to natural market fluctuations, to restraint of trade, or to

exploitation of the individual, they are usually determined causally by the comparative scarcity of the desired product; and may, therefore, be measured exactly by the difference between the cost of production and the market price. The first class of profits, however, are earned incomes; that is, returns for economic effort, while those designated here as scarcity gains are surpluses above costs and wholly the result of the fluctuating intensity of demand forces. Even tho scarcity profits may be induced by a fluctuating supply, they are not the result of economic sacrifice. This plan of classification is most pertinent to a differentiation of the intra-marginal profits of the more efficient producers; but obviously it will be found by careful comparison to run counter to both the previous surplus and labor theories of present-day writers.

In presenting a distinct theory of efficiency profits, we shall rely partly on the fact that this dynamic function of the entrepreneur is fully recognized in American law, and that his peculiar ability, or inventive faculty, is readily distinguished from the mechanical skill of the mere laborer, manager, or superintendent. The sacred right of every man to possess exclusive ownership in his own secret or discovery is a sort of inalienable right which has come down to us from ancient times, and more recently been hedged about with legal barriers. This right extends even to little things. Thus a workman, while in the employ of his master, changed the direction of a pipe entering an iron mold so that the dross in the molten metal was thrown toward the center. The employer claimed the invention. Yet in the application of the legal principle to this simple case, the court raised the inventive powers of the workman above the field of routine service, and made this act of the laborer wholly independent of the claims of his employer. This

exclusive right of the entrepreneur extends, of course, to inventions, discoveries and trade secrets. But the strictly defined legal sphere of invention includes, in the opinions of the courts, only the highest order of dynamic service performed by the entrepreneur. The design of the patent law is to reward only those who have made some substantial advance in the useful arts.[1] The subject of a patent must, therefore, embody something more than what any skilled workman, if called upon, could produce; something more than what may seem to involve the exercise of extraordinary mental powers in the everyday work of laboratory routine.[2]

In this connection, however, if a much desired result is secured through a patented device, which has never before been attained, want of invention cannot be maintained on the ground that it is merely a combination of known elements[3] or that it is so simple in construction that any one can make it.[4] Certain it is, tho the sphere of invention is strictly limited and narrowed by analysis and definition, the significant fact remains that the slightest *invention* in business and the faculty which creates it, are legally recognized as in no way connected with the routine conduct of an enterprise.

[1] Atlantic Works v. Brady, 107 U. S. 199, 200; Tiemann v. Kraatz, 85 Fed. Rep. 349.

[2] Badische Anilin and Soda Fabrik v. Kalle, 94 Fed. R. 173; Perkins Electric Switch Manufacturing Co. v. Gibbs Electric Manufacturing Co., 87 Fed R. 923, 924; Vinton v. Hamilton, 104 U. S. 491. Again, it is not enough that an improvement is new and possesses great economic advantages for it to rank as an invention, it must be the product of the inventive powers. (Magin v. Karle, 150 U. S. 391; Burt v. Evort, 133 U. S. 349; Hild v. Wooster, 132 U. S. 700; Watson v. Railway Co., 132 U. S. 161; Munson v. New York City, 124 U. S. 610; Morris v. McMillan, 112 U. S. 247.) Thus it is not an invention to duplicate the parts of a machine unless the alteration in it causes a new mode of operation. (Dunbar v. Meyers, 94 U. S. 197; Slawson v. Grand Street R. R. Co., 107 U. S. 653; Millner v. Voss, 4 Hughes, 262.) Neither is the mere act of assembling processes, machines, or enterprises to be classed as invention. (Hailes v. Van Wormer, 20 Wallace, 353; Reckendorfer v. Faber, 92 U. S. 357; Pickering v. McCullough, 104 U. S. 318.)

[3] Loom Co. v. Higgins, 105 U. S. 591.

[4] Dubois v. Kirk, 158 U. S. 63; Potts v. Creager, 155 U. S. 608, 609; Krements v. Cottle Co., 148 U. S. 561.

Consequently, it stands out as a part of that dynamic function which the entrepreneur alone exercises.

But this legal right of the entrepreneur extends also to trade secrets; and in this relation he possesses several legal methods of preserving the results of his peculiar dynamic efficiency. Tho he may not secure letters patent for his device, he may, perhaps, preserve it for a longer time through secrecy. In the first place, this function of the entrepreneur is protected from the public and from his own employees. It is a well known rule of law that where an employee has entered the service of another and has had imparted to him the secrets of a business, he is bound without an expressed contract to preserve them as sacredly as his own.[1] This right of the entrepreneur extends to a secret code used by him in entering prices in a trade catalogue; one who obtained the key to the code so used, was enjoined by the court from disclosing the information to others.[2] Similarly, a counting house clerk was not allowed to make known what he had learned in performing his duties.[3] In like manner, an engine maker's clerk, who had made a table of dimensions of his employer's engines, was prevented from using or disclosing the data so obtained.[4] In a like instance an injunction was granted to prevent the publication of etchings made simply for amusement.[5] So in a bankruptcy case, one who owned a secret process in the business was allowed to remove all machinery necessary to prevent its disclosure to others. A slight change in the method of manufacture may, of course, be of great advantage to the entrepreneur; but if the general process is well known, he may be unable,

[1] Simmons Med. Co. v. Simmons, 81 Fed. Rep. 163.
[2] Simmons Hardware Co. v. Waibel, 1 So. Dak. 488.
[3] Tipping v. Clarke, 2 Hare, 393.
[4] Merryweather v. Moore, 61 L. I. 506.
[5] Prince Albert v. Strange, 18 L. J. 120.

except through a contract with his employees, to protect his trade secret. For example, in one instance, a method of collecting insurance was disclosed to an agent without binding him to secrecy, and it therefore became common knowledge.[1] Again, of several manufacturers making a well known soap, one who succeeded by a slightly changed process in making a better article than that produced by the others, was unable to maintain in court that he possessed a secret process.[2] In another instance it was impossible to secure an injunction to protect a secret process for making pills, for the court decided that it would be unable to discover whether the method had been infringed upon unless it were disclosed in court.[3] From these illustrations it is plain that wherever possible the peculiar dynamic efficiency of the entrepreneur is protected by law from his employees and the public. In fine, against those who have surreptitiously gained knowledge of his trade secrets, the entrepreneur's right of relief in equity has always been recognized.[4]

It is also a significant fact that the law distinguishes between mere managerial ability and the peculiar powers of the inventor. That is, the inventive faculties are emphasized and raised above even the skill of a general manager. In Hapgood *v.* Hewitt a general superintendent of a manufacturing department had also agreed to devote his time and services "to devising and getting up ploughs for the corporation" by which he was employed. The finding of the court upon the evidence is most pertinent. It was declared "(1) that

[1] Bristol v. Equitable Life Assurance Society, 132 N. Y. 264.

[2] Bell and Bogart Soap Co. v. Petrola Manufacturing Co., 54 N. Y. Supp. 663.

[3] Newberry v. James, 2 Meriv. 451; see Williams v. Williams, 3 Meriv. 158.

[4] Fralich v. Despar, 165 Pa. St. 24; Stewart v. Hook, 118 Ga. 445; Salomon v. Hertz, 40 N. J. Eq. 400; Thum Co. v. Tloczynski, 114 Mich. 149; Peabody v. Norfolk, 98 Mass. 452.

Hewitt was not expressly required, by his contract, to exercise his inventive faculties for the benefit of his employer, and there was nothing in the bill from which it could be fairly inferred that he was required or expected to do so; (2) that, whatever right the employer had to the invention by the terms of Hewitt's contract of employment, was a naked license to make and sell the patented improvement as a part of its business, which right, if it existed, was a mere personal one, and not transferable, and was extinguished with the dissolution of the corporation." [1] In Illinois the mere fact that a superintendent received wages, materials, and assistance from his employer while making his models did not give the latter a right in the invention itself. The peculiar function of the inventor or entrepreneur, as we would describe him, has been carefully distinguished by a court of that state: "An invention is the product of the mind, and the making of models and performing of the experiments are only mechanical operations and mere labor performed for appellant (the inventor) under his direction, for which he would be liable to be charged, or the time lost deducted from his wages or time. As between employer and employee, the right to the invention belongs to the one who conceives the idea, and follows it out to practical invention." [2] The contents of these two decisions have an important bearing on the labor theory of profits, for they go to the heart of this complex question of the entrepreneur's function and point out what is all-important. They rightly distinguish the inventive powers of the entrepreneur, lend emphasis to his peculiar dynamic efficiency, and separate in a thoro manner his sphere of activity from that of the manager.

[1] Hapgood v. Hewitt, 119 U. S. 233; see Peabody v. Norfolk, 98 Mass. 460; Dalzell v. Deuber Manufacturing Co., 149 U. S. 320.

[2] Dice v. Joliet Manufacturing Co., 11 Ill. App. 114, citing Agawan Co. v. Jordan, 7 Wall. 603; Collar Co. v. Van Dusen, 23 Wall. 563.

We have, therefore, concluded that to confuse the superior function of one who furnishes an invention, discovery, or trade secret with the services of superintendence and management is to prevent proper analysis, and to neglect the earned profits of efficiency. Nay, more, it serves to defeat the full purpose of the labor theory of profits; for what is so obviously patent of the invention function is also true of all dynamic services of the entrepreneur. There is room for a labor theory of profit; but in its present form it includes too much, and, therefore, defeats a proper analysis of the residual income. That is to say, by merging this peculiar dynamic efficiency into the labor concept of profits, we have failed to recognize the importance of a service which really forms a proper foundation for an *efficiency theory of profits*. Hence by means of the foregoing excerpts we have sufficiently emphasized the inventive powers of the undertaker as a basis of efficiency profits. At the same time, it has been our intention to separate them from the activities of mere labor, and to show that the labor theory of profit is not in harmony with the present conditions of industry.

It has, however, been noted that the entrepreneur's dynamic activities contain something more than the creation of inventions and trade secrets. Stated concisely, there still remains the important elements of judgment, control, and risk-taking. No group of laborers, however adaptable, skilled and aggressive can, as such, perform these tasks of the entrepreneur. Upon the element of judgment must depend the acceptance or rejection of all new ideas and changes leading to the successful expansion or contraction of industry. This is obvious from the very fact that whether new ideas — as they take the form of abstract capital — are the product of his own mind or are furnished to him by

others, he alone embodies them in the productive process; that is to say, takes the risk and responsibility of using them. Judgment is simply an indispensable part of the entrepreneur function — the very leaven to industry; and extends to every material unit and active service utilized in a dynamic enterprise. It accepts the methods of control to be used, the forms of coördination to be established, and the proper risks to be taken. It unlocks the door to success in every venture whether it be only the small corner stand of the popcorn vender or the vast empire of the railroad magnate. In relation to the entrepreneur's services it forms the cement to industry. It binds the functions of control, coördination, and risk-taking into a concrete working unit; and these powers distinguish his dynamic function from that of the laborer and the capitalist.

At this point let us compare briefly the profits of efficiency with the scarcity surplus. The efficiency profits of the intra-marginal producer no more resemble the scarcity or speculative profits above the competitive plane than do real wages and natural interest. Profits of efficiency arise from successfully reducing real costs of production. We may note, for example, that every new capitalist, laborer, or entrepreneur who supplants a less capable one, increases the supply of productive services, the amount of efficiency profits, and decreases at the same time scarcity gains. By creating newer and more efficient enterprises, the entrepreneur reduces, then, to some extent the previous scarcity of capital and commodities. A sudden increase in demand may, of course, cause the appearance of speculative profits, but to say that increased production alone means a greater scarcity of economic goods is asserting an absurdity. More economic processes and more commodities are produced through the increased efforts of the more

efficient entrepreneur; and, moreover, he is entitled to that part of the increased product which compensates him for his added outlay and his risk disutility — a true differential. To compare this increment to speculative profit or to rent is confounding the real product of efficiency with a scarcity surplus.

The surplus theorists, it is true, rightly emphasize the existence of a speculative profit above the cost of production, which tends to disappear as industry approaches a static state. Their service in this respect has drawn our attention to this form of the unearned surplus and its relation to production. Moreover, if accountants can determine the cost of an article, they are certainly able to ascertain the amount of the unearned increment, which is simply the difference between the costs of production, including efficiency profits, and the market price. But when economists make this surplus identical with the efficiency returns of the entrepreneur, certain fundamental differences between the two forms of profit are overlooked. The two incomes hold entirely different relations to price, and, as has been noted, arise from wholly different causes. Speculative profit is *determined* or measured by the scarcity price; efficiency profit, on the other hand, aids in *determining* or fixing the normal price. The latter return is a cost of dynamic changes in production, is governed by the technical laws of industry, and corresponds to a given positive effort on the part of the entrepreneur in the technical process of production. The former is solely a phenomenon of value, is governed by the law of demand, and corresponds to a given human desire in the process of consumption. Efficiency profit tends to increase generally by virtue of increasing individual efforts to reduce costs below the competitive plane, and the rate varies between producers; speculative profit

tends to increase, as a whole, by reason of increasing competitive desires and demands of consumers, and the rate of increase, where price rises uniformly, is the same for all producers. One is due to the increased services and efficiency of the producing agent, the other to the latter's scarcity and the limitation of its producing power. It is, of course, plain that this surplus theory will not explain adequately the origin of the entrepreneur's various incomes; and it is none the less obvious that even in a static society, an efficiency or differential profit will continue to exist until all human powers have become paralyzed and the forces of nature have ceased to work.

We may return now to the more conservative view presented by the labor theorists. The labor theorists, from their side of the controversy, have overlooked three important things which the actual conditions of industry make it necessary that the economists should observe. In the very beginning, they do not differentiate the peculiar dynamic efficiency of the entrepreneur from his labor function. To this function we have credited largely changes in production and the creation of efficiency profits. But as the economic world is now constituted, the wide range of this dynamic efficiency covers a multitude of questionable acts, which, under the guise of able pioneering, are commended by both legalists and economists as just endeavors to obtain the more lucrative gains of progress. However, confined to its proper sphere, this dynamic function, as we would restrict it, consists in incorporating ideas or abstract theories into the productive process and taking the necessary risks on them. On the side of concrete production, as distinguished from the field of consumption, this function serves a highly useful purpose; it is, in fact, the highest order of effort known in industry. But

in the fields of exchange and distribution this service, through the coercion of demand and consumers, may assume the form of legal robbery. By way of illustration, in the correlation of supply and demand, the entrepreneur's efforts to secure a permanent market, to direct and control the flow of trade, and to outdistance his rivals, have assumed such elaborate schemes that his peculiar dynamic efficiency must certainly be recognized as overshadowing the nominal function of labor. By absorbing into the labor concept of profit the most important, and at times the most injurious acts known to the economic world, these theorists have avoided a most needed analysis. In fact, in the zealous endeavor to include all profit incomes in the labor concept, the latter theory has been so extended in scope that it now embraces the entire skein of tangled profit notions from the meager hard-earned wages of labor, on the one extreme, to the abundant harvest of unearned good will surpluses on the other. Obviously, the doctrine that the whole varied range of incomes of a successful business man are simply the returns of labor, is fully as misleading to jurists, statesmen, and business men as its exact antithesis — the surplus profit theory — *is unscientific and untrue.*

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Profits of Efficiency

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PROFITS OF EFFICIENCY

In this discussion a definite method is presented for separating the earned returns of efficiency from the wholly unearned surpluses of the market and of goodwill. The view is taken here that efficiency profits are due directly to the entrepreneur's struggle in the technical field to reduce outlays or to increase the quality or quantity of output. In the first place, he may, of course, reduce the costs of production or enlarge the capacity of the technical processes and finally the output of an industry. His efforts result largely in a relative increase of desirable utilities, mainly through an increase in the creative or positive forces of production. In any successful enterprise these forces augment, then, the concrete utilities and the residual surplus of the entrepreneur; and that part of the output which is thereby added is, therefore, described here as the positive profits of utility. These returns constitute the key to any careful analysis of efficiency profits. On the other hand, he may be content to add to an established process only those services which reduce technical and market risks and thus serve merely to preserve the present elements of production and the normal output of an enterprise. Obviously, such measures ward off injurious forces, are preventive rather than constructive, tend to keep an enterprise from falling below the productive margin, and consequently yield the entrepreneur different forms of negative utility profits. These various incomes of concrete utility require careful and critical examination.

Efficiency returns of the first form, then, are from their very nature positive utility profits. They arise only by the creation of added utilities through an increase in the positive forces of production. Whether values are high or low each individual engaged in producing profit is entitled to his own services, to what he alone creates, and hence to any increased utility which may be the result of his own effort. This utility may be measured—according to the nature of his sacrifice—by an increment added to the output or by one taken from the total outlay which was not previously made for protective purposes. Measured in terms of value, this profit is equal to the difference between the expenses per unit of the added output of the intra-marginal producer and the cost of production at the margin. These facts alone are sufficient to distinguish them from what are commonly known as risk and speculative gains.

The origin or present existence of utility profits, which are solely the result of increased positive forces of production, may be given due emphasis in several ways.

1. They often occur as a direct result of the constructive changes which supply much desired products with very little risk to the entrepreneur. Thus the chemist and the physicist are constantly discovering new applications of nature's forces; and after definite scientific methods have been carefully perfected, no great hazard is taken in adopting such new productive processes. It is plain that the corresponding utility profits include that part of the added product which is due to increased advantages not counterbalanced by frequent risk losses.

2. Again, the law recognizes the existence of positive utility profits by the manner in which it guards the legitimate trade secrets of the entrepreneur. By way of illustration, an implied contract is presumed to exist between men who jointly venture, or assume confidential relations in a business, that they will not reveal trade secrets imparted to them. This legal principle has preserved for many a shrewd enterpriser the hard-earned rewards of his own efforts.

3. It has also been emphasized by American judges that the inventor, whether he be workman, manager, or partner in an enterprise, may exercise this part of the entrepreneur's function with full assurance that he will be protected in realizing the profits of his invention and discovery. In fact, unless there is a particular contract to the contrary, an employer can secure nothing more than a shop right to any invention that his workmen may have made.

4. The profits of efficiency are also protected by trade-marks which are usually affixed to secret preparations. If an article is manufactured under a valid trade-mark neither the process nor the mark may be used by competitors.

5. In no less degree, the law has recognized efficiency profits in the patent systems of England and the United States; for without the inventive power there would have been no patent law. It is in recognition of this peculiar ability that the state undertakes to guarantee to every man for a limited period the exclusive manufacture and sale of his own product. Obviously, the great number of patents issued annually furnish abundant evidence of the efforts put forth by thousands of inventive minds to secure greater utility profits, which are determined by a better or greater total output.

Positive utility profits of this kind accumulate with great rapidity in commerce, transportation, and manufacturing industries, but especially so when enterprises are in the state of increasing returns at an increasing rate. Thus in the competition between parallel railroads for freight traffic, utility profits are augmented with increased patronage, and rates may be established for the more successful lines upon a cost basis. The public gains, of course, through the competitive struggle under the laws of efficiency; for rates constantly tend to decline. Nevertheless, in no other case are profits of this description so plainly the result of ceaseless energy and constant sacrifices, multiplied in the race for wealth and power—the real income of enterprise.

In agriculture, however, positive utility profits are so closely associated either with the speculative surplus or with rent that writers often fail to distinguish them. In opposition to the scarcity and the niggardliness of land is to be reckoned the increased efficiency of improvements which reward the entrepreneur in the profits of utility. An improvement in agriculture may be subject either to the law of an increasing rate or of a diminishing rate; which, at first, must result in an efficiency profit to the tenant. However, in some instances such differential gains may be transferred to the landlord because of peculiar circumstances. Two examples here will suffice. A tenant was able, by a unique device and the use of dynamite, to drain a swamp and thereby increase its value tenfold. Another by sinking tubular wells in Colorado made possible the irrigation of wild land. In each of these instances the advantages of increased production went ultimately to the landlord, although some part of the increased output was undoubtedly justly due the tenants as positive utility profits. New natural forces were in each instance brought into operation, and from these the landlord was, of course, entitled to rent; but for their utilization and the sacrifices of invention the tenant should have received a fair return.

Efficiency returns of the second general group, which we are here describing as negative utility gains, appear whenever the entrepreneur is seriously engaged in the task of preserving his product—that is, both the industry and the output. Such efficiency profits are, therefore, due mainly to his successful struggle against chance or uncertainty and to his elimination of some important negative element. It is probably plain that a New York merchant who is able by introducing an automatic system of fire

protection to effect a reduction of fifteen thousand dollars a year in his insurance cost is adding that much to profits. If a vessel loaded with perishable freight becomes stranded, the element of risk outweighs all other considerations; every effort is made to rescue both cargo and vessel. Partial destruction often occurs and the immediate object is to reduce risk losses. Furthermore, desperate efforts have recently been made to protect crops from the ravages of insects, and stock from sudden epidemic. In like manner any defensive measure in production is an effort to prevent a risk loss; for to relinquish a technical advantage, after it has once been secured, means increasing risk and necessary loss.

In this second class of efficiency returns are to be described, first, the important internal risk profits of an enterprise. Such gains in utility come by reducing the losses from certain internal economies of production. All protective measures used for the preservation of the physical properties of the output or the process itself are to be counted as internal economies, and this particular group of negative utility profits arises from efforts which preserve the concrete product and prevent its destruction or deterioration. Thus thick walls preserve the ice contained in the refrigerator car; and the ice in turn preserves the fruit or meat placed therein. Again, the outlays required in such measures as spraying fruit trees or grain stored in elevators to kill insect pests are to be counted as sacrifices of production. In fact, these constitute a form of risk costs. The immense expenditure in the United States for protective measures may be seen in the extensive building of dikes, ditches, and canals. At many points it is necessary to construct wharves and warehouses for storing commodities. And in no less degree are the mine and farm owners called upon to protect the products of the earth. All outlays of this nature eliminate a negative element or force; and are obviously to be separated by careful analysis from those costs which increase the positive forces of production. In fine, the first are definite outlays against risks, and as such serve to reduce the losses of a business.

A strong contrast exists here between positive utility, and internal risk, profits. Positive utility profits have their origin in the production of added salable commodities at the prevailing price, while this particular risk profit is the result of preserving or redeeming such utilities from threatened loss or disuse. Dredges used in building canals for carrying commerce create new wealth;

but the same means used to draw off water from a partly submerged city is only a protective measure. Again, a hydrant may serve to augment positive utility profits by bringing new areas under cultivation; or as a method of protection it may be needed to save a fire-stricken section. Positive utility profits accrue when a second or third shift of laborers is added to an enterprise; but the number of accidents to each man will be even greater than before, and consequently the cost of insurance or of safety devices will increase. Now it is to be noted that positive utility gains and internal risk profits may be the result of two different processes, as in the illustrations given above. The first gains usually originate in the main process of production, but their preservation is often due to some secondary means. Consequently, the risk profits of utility in the secondary process are frequently equivalent to previous risk costs or losses in the first group of returns. However, when utility-forming and risk-eliminating processes are closely associated, the task of separating positive utility gains from risk utility profits is much more difficult; for example, the treating of wheat before planting or inoculation of alfalfa seed to avoid subsequent loss. If a veterinarian arrives just in time to save a sick horse, he creates a much desired utility for which he is given a corresponding compensation; and the owner of the horse has, perhaps, saved its entire cost and efficiency to himself. That is, internal risk profits of an enterprise are simply utilities, measured in terms of marginal cost, which have been saved from loss, deterioration, or destruction. A positive utility profit is the direct result of an added productive force; a risk profit is a utility profit rescued from destruction. If a utility saved by a certain act or process cannot, however, be separated from accompanying losses, its creation undoubtedly prevents a still greater loss; and, while not adding a surplus utility, it does, nevertheless, establish a negative gain or profit. This last rule is well established in law, for it is used in courts of equity to measure differential profits.

Now the entrepreneur is usually drawn into a new field by the prospect of both positive and risk utility profits; and, as such returns are limited finally by his operations under the technical laws of efficiency, they become, as will be seen, costs of production and price determining. That is to say, his chief purpose is not to assume risks but to avoid the burden of taking them. Opportunity to increase commodities at little risk, as in the lumbering

industry, attracts large investments. But as a rule such utility profits must be sufficient to induce entrepreneurs to enter new fields or to make alterations in their processes of production. On this ground, they are costs measured by the entrepreneur's estimate of his own services. Stated concisely, to secure the added output, the undertaker is usually obliged to assume greater proportionate outlays because of these technical laws and to accept a less rate of profit. Though he receives a greater total profit, his costs rapidly approach the competitive plane. Consequently, the general attitude of entrepreneurs toward enlarging their output usually regulates these profits of utility. Still, because of hidden risks this gain is less at times than the undertaker may have expected.

In case costs per unit of product rise with such increased risks, an enterprise can only adjust its expenses to the prevailing price by reducing its output. And the flexibility of an enterprise allows this process to go on until the extensive margin is reached. In other words, as the point of highest rate of profit in a flexible enterprise is also that of lowest cost per unit of output, increasing risk costs or losses may gradually compel the producer to diminish his total product until this point finally coincides with costs at the extensive margin. Certain it is, that this marginal enterprise assists at this point in the determination of price. For whether price is stationary or constantly changing, the total output cannot be secured at a lower expense; and as such risk costs are a definite barrier to a further increase in production they are, therefore, price determining. On the other hand, with the invention of a device that reduces losses, internal risk gains or profits are accumulated; and an enterprise may then increase its output with a greater total profit at some point above that of minimum efficiency. That is, the enterprise is now above the extensive margin and, as an intra-marginal unit, its accumulation of profits is checked only by the competition of others. Hence, in such instances both positive and negative utility profits are finally determined at the point of greatest net output. Above all, the operation of the technical laws of efficiency, in the usual adjustment of productive processes, establishes a general *cost line* which, under freely competitive conditions, separates utility profits from unearned gains, and makes the former price determining.

The second class of negative utility gains are external risk profits. These are obtained by overcoming losses in the external economies of production. Measures taken to prevent (a) the

fluctuation of money costs in outlays or to secure (b) a permanent market for finished goods generally decrease risk losses. It will thus be seen that external risk profits are of two distinct kinds, and that they depend directly upon overcoming the speculative elements in purchasing the factors of production and in selling the finished product. In the first place, such losses are reduced by long-period contracts which fix wages; by the importation of laborers; by the purchase or lease of mineral, timbered, and ranch lands to secure raw products; and by establishing or purchasing enterprises supplying needed materials. A case in point is that of a steel corporation which has purchased mineral lands in Minnesota; it is now securing its iron ore at seventy-five cents a ton. This company no longer fears the risks from the fluctuations in the price of iron ore. A small part of such expenditures, as this particular investment in mineral land indicates, should be counted as insurance against loss. It is patent that where industries are thus united by contract or purchase, the injury to society by combination and integration of related enterprises appears only when they are able, after having secured the economies of efficiency, to force values permanently above the cost of production, as determined by the laws of efficiency. Efficiency profits from overcoming external risks are then obscured by the appearance of unearned artificial gains. From the legal standpoint, however, such contracts are valid until there is tangible evidence that they have become the basis of a monopoly.[1]

On the other hand, external risk profits are also due to a judicious expenditure in perpetuating the demand for a commodity or in establishing a fixed market by increasing the goodwill of a business. The cost of advertising, which amounts at times to considerable sums, should be included here. But far more important to such risk profits are the contracts by which all of a customer's patronage is secured. Or again, of like nature is the agreement of a wholesale merchant that he will sell a certain commodity to but one dealer in a designated city or state.[2] It was not illegal

[1] In this connection, we may note that such contracts were used to control the supply of lumber in certain counties in California, and of grain bags in another part of the same state. Similar contracts regulating the amount of coal shipped to Elmira, New York, were declared void as being against public policy. In this respect, a combination based upon agreement generally affects risk profits over a wider area than does one based upon purchase of much needed industries.

[2] *Clark* v. *Crosby,* 37 Vt. 188; *Newell* v. *Myendorff,* 9 Montana 254; *Keith Optical Co.,* 48 Ark. 139; *Roller* v. *Ott,* 14 Kan. 615, 616.

for a railroad company in Missouri to bind itself, in return for wharf privileges, to send all of its freight and passenger traffic over a certain ferry line;[3] or in Indiana for a saloon-keeper to agree to purchase his stock of beer from a prescribed brewery.[4] No less important are the agreements between retail dealers to compel wholesale merchants to remain entirely out of retail business; for the courts in these cases were of the opinion that it is often legal to make contracts for the express purpose of decreasing the profits of others.[5] Obviously, such contracts secure a definite and reliable market for the output of an enterprise at a small risk expense. Moreover, this outlay reduces the losses arising from delayed or irregular sales, and whatever sum is saved under freely competitive conditions may be credited[6] as an efficiency profit to this form of contract. Despite this advantage, however, it is certain that trade channels often become fixed by such arrangements, competition is restrained, and not seldom these agreements enhance prices and form monopolies.[7] Yet in many cases uniform prices extending over wide areas, which have been established by agreement or custom, illustrate only the inevitable effort of men to overcome external risk losses.

Certain it is that the public is unable to discriminate between the earned and unearned returns of large enterprises; and economic writers whose peculiar duty it is to investigate this phase of modern industry have neglected the various forms of legal profits. It is just at this point that juristic opinions furnish important material for discerning economists. In fact, that branch of the law which relates especially to patented inventions makes easier the task of distinguishing the foregoing efficiency profits; for in this field such returns are often reckoned upon the producing capacity of the concrete process. If one producer uses unlawfully a patented article or process owned by another, he becomes an infringer upon the latter's rights and may be held legally responsible for the gain made by the infringement. In estimating

[3] *The Wiggins Ferry Co.* v. *Chicago and Alton R. R.*, 73 Mo. 390, 405.

[4] *Ferris* v. *Brewing Co.*, 155 Ind. 539.

[5] *Bonn Mfg. Co.* v. *Hollis*, 54 Minn. 233; *Ertz* v. *Produce Exchange*, 79 Minn. 144; *Macauley Bros.* v. *Tierney*, 19 R. I. 259. See, however, *Jackson* v. *Stanfield*, 137 Ind. 615; *Brown* v. *Jacob's Pharmacy Co.*, 115 Ga. 442.

[6] When such contracts are broken, the plaintiff is usually allowed to collect his prospective profits in the form of damages.

[7] *Boutwell* v. *Mars*, 71 Vt. 1; *Olive* v. *Van Patten*, 7 Tex. Civ. App. 630; *Judd* v. *Harrington*, 139 N. Y. 105.

these profits a definite rule is followed. The advantage which this first entrepreneur derives from using the patented device over that accruing from any other process known prior to that invention, in accomplishing exactly the same result, constitutes the profits which the complainant is entitled to recover.[8] Thus in the case of the Cawood patent[9] a certain railroad had used, without the inventor's permission, a patented swage-block for the purpose of repairing the ends of steel rails which had become exfoliated by wear. It was held by the court that the gain in mending rails by the use of the patented implement compared with the cost of mending them on a common anvil, including the saving in fuel and labor, was the proper measure of damages. Needless to say, other examples might be selected to emphasize this method of determining efficiency profits by the use of a legal standard of comparison, which in each case is the next most efficient process giving the desired result.[10]

If only the patented process under consideration and one other would serve the particular purpose of production in any case, we should have the stock illustration of the economist. That is, the latter process would determine the extensive margin of production from which the efficiency profits of the former would be measured. And inventions are not so varied or so numerous that examples of this are infrequent. As we have observed, the defendant under the Cawood patent was obliged to pay the difference between the expense of repairing his rails by the patented process and that which he would have incurred had he used a common anvil. Either the outlay of swaging them on an anvil or of rerolling them should be taken as the marginal expense of production.[11] In *Thomson* v. *Wooster* the master in chancery allowed the complainant all the profits which the defendant had made by the use of a patented machine in folding strips of cloth over what his expense would have been in having the same tasks done by hand.[12] In still another instance, the decreased expense of splitting wood by a patented device, in comparison with doing

[8] *Cawood Patent,* 94 U. S. 710; *Mevs* v. *Conover,* 125 U. S. 144, note; *Tilghman* v. *Proctor,* 125 U. S. 144; *Mowry* v. *Whitney,* 14 Wallace 649; *Sessions* v. *Romadka,* 145 U. S. 49.

[9] 94 U. S. 695, 710.

[10] See *Mowry* v. *Whitney,* 14 Wallace, 649; *Williams* v. *Rome and Ogdensburgh Railroad Company,* 18 Blatch. 185.

[11] 94 U. S. 710.

[12] 114 U. S. 116.

it by hand, has resulted in a differential gain for the owner of the invention.[13] A similar case is that of *Sessions* v. *Romadka.* The advantage secured by the defendant consisted in the difference between the cost of making certain patented fasteners, which he had used in manufacturing trunks, and the greater outlay for straps, buckles, and dowels, previously used for the same purpose. In cases of this character, the differential advantages or profits have in some instances been measured in positive gains, but in others there has been only a reduction of prospective losses. Yet the differential advantage forms in each case the court's measure of the inventor's legal profits.

Indeed, emphasis may be placed upon the different forms of efficiency profits and their practical significance by referring to the decisions of certain cases which illustrate this rule. For example, positive utility profits are obtained in all those instances in which the differential advantage of the patented process over the less efficient ones is so marked that a greater surplus output results from its use.[14] It is often true that the utility profits so obtained are produced from materials which otherwise would be useless or of little value in other processes.[15] The methods of the inventor have then brought into use new technical forces, and his rewards consist almost entirely of prospective utility profits. In the end, however, the final output depends upon the superiority of the truly positive, over the noncreative, forces of production. But if this product is the result of several independent acts, the utility profits of one process are often counterbalanced by losses from other methods in the same enterprise. There has, however, been a negative gain over the opposing elements of nature.

It seems necessary to illustrate this last statement with several examples. In an important suit, the defendant had for several months used independently several solvents, including a patented process, in the treatment of pyroxyline. Because of a defect in the pyroxyline the various treatments were unsuccessful and the resulting products could not be sold at a profit. Nevertheless, the master in chancery decided that as the patented solvent was much cheaper than the others used, the defendant saved a sum

[13] *Mevs* v. *Conover,* 125 U. S. 144 note.

[14] *Piper* v. *Brown,* 1 Holmes, 198; *Rubber Co.* v. *Goodyear,* 9 Wallace, 801; *Elizabeth* v. *Pavement Co.,* 97 U. S. 138; *Tatham* v. *Lowber,* 4 Blatch., 87; *New York Grape Sugar Co.* v. *American Grape Sugar Co.,* Fed. Rep. 456.

[15] *Rubber Co.* v. *Goodyear,* 9 Wallace 801; *Elizabeth* v. *Pavement Co.,* 97 U. S. 141.

which the complainant was entitled to recover as profits. "From these findings," declared the court, "it is apparent that, to the extent the defendant used the patented solvent, the use of the other was superseded in its experiments and operations in treating pyroxyline. The case is therefore one where, by the use of the patented invention, the defendant has been saved a greater loss than it otherwise would have sustained. To this extent it has derived an advantage by the use of the patent."[16] Again, in the case of *Mevs* v. *Conover* there was a saving of labor in splitting kindling-wood by means of a patented machine in comparison with the work of doing the same task by hand. No actual profit was made by the infringer of the patent, it was claimed, but the court decided that "his loss was less to the extent of seventy-five cents on each cord split, than it would have been had he not used the patented invention." It seems that a similar decision was first reached in *Black* v. *Thorne*,[17] which was later reversed on the ground that there was no positive proof that the defendants in the case had made any profits whatever from the use of the plaintiff's patented improvements.

In not a few decisions we find that reference is made both to (a) the saving from decreased costs and to (b) the addition of positive utilities. These facts illustrate two important forms of positive utility profits. Thus in *Tilghman* v. *Proctor* it was found that in the manufacture of glycerine, a certain patented process was superior to any other known method. It had saved the defendant in the use of lime and sulphuric acid the sum of $182,-731, while there had also been a gain in the production of glycerine amounting to $62,000. And again, in determining the profits from an unauthorized use of a patented invention for the purpose of manufacturing oxide of zinc from zinc ores, the master in chancery made a careful computation of the (a) coal and labor saved by the new process, (b) the increased amount of oxide of zinc obtained by it from a given weight of ore, and (c) the quantity of residuum available for renewed treatment which was also saved to the manufacturer after his adoption of the new process. These facts certainly furnished the court with accurate information concerning the direct saving in expenses of production and the amount added to the total output of utility profits over other processes. Yet, strange to say, the court rejected these rather

16 *Celluloid Mfg. Co.* v. *Cellonite Mfg. Co.*, Fed. Rep. 478.

17 111 U. S. 123.

refined calculations which undoubtedly proved the great superiority of the patented process. The decisive objections to the master's report, as given by the court, were that the result, thus obtained, necessarily fluctuated with the varying richness of the ore treated, and that the defendants were charged with the third item to which no value was given by the patented process. "The simplest and most appropriate method is," stated the court, "to ascertain the quantity of oxide obtained by the use of the complainants' process, and the cost of its production, and comparing this with the cost of producing a like quantity by the muffle process, the difference is the saving due to the former."[18] Of the two methods presented here, it is obvious to one familiar with the treatment of ores that the former one was much the more accurate and scientific. In selecting the figures showing the comparative costs of producing one hundred pounds of oxide under both the old and the new processes no account seems to have been taken by the court of the quantity of ore wasted under the old process. In the master's estimate we have, on the other hand, a distinct statement of the savings of ore formerly wasted, and also the added profits from an increased proportion of oxide from the ore used. In fact, the method presented by the master resembles very closely that used to determine the profits of the defendant in *Tilghman* v. *Proctor.*

However, if the patented process has effected at most only the preservation of an added product, or a saving from what would otherwise have been a loss, the advantage in the form of output may really be measured or estimated as internal risk profits. This follows from the fact that a risk profit is a utility profit which has been saved from destruction or loss. Thus, for example, in *Piper* v. *Brown*[19] certain fish, which under other circumstances would have spoiled, were so well preserved by a patented process that they were disposed of at a normal profit.[20] In the case of the Cawood patent otherwise useless rails were again made serviceable, and the invention clearly saved a risk profit. It was, indeed, argued that no profits were made by the use of the patented process and that it would have been more economical if the rails had been rerolled before again being laid. Upon this point, however, the court was not to be turned from the rule relating to

18 *Wetherill* v. *Zinc Co.*, 1 Bann. and Arden, 487, 488.
19 1 Holmes 198.
20 See *Piper* v. *Moon*, 91 U. S. 44.

the existence of a differential advantage.[21] In fact, in the various circumstances in which a process simply saves what would otherwise have been a loss, this saving has often come, not from added utility, but from lessened costs of preventive measures; and the decreased loss may be taken as adding to the entrepreneur's risk profit. In reviewing many cases, one is struck by the large number of instances in which risk returns were found to be present, though no profits were obtained from the general business. This fact emphasizes again the important place held generally by internal risk profits in manufacturing industries.

Whether the differential advantage of an invention rests mainly upon an increase in positive utility, or in risk profits, the rule of division between the infringer, who merely uses unlawfully the protected process, and the patentee is obviously plain. The latter possesses here no legal right to the surplus speculative profits of his patented device or to the returns from any other elements of the business. At times the expense of production under a patented process and other outlays cannot be differentiated, and the plaintiff is then allowed all profits accruing from the entire process. But the rule is nevertheless inflexible; the latter is entitled only to the earned increment which is equivalent to his economic advantages measured in costs over the standard of comparison. It is the custom for the latter to select what he considers the proper standard, and to present proof of the resulting advantages which the defendant derived from infringing upon his invention. The defendant, on the other hand, may accept the standard so selected, or he may set up one more favorable to himself. But in any case, the final award by the court rests upon appropriate and pertinent evidence pertaining to the utility and superiority of this invention over old modes or devices that have been used for working out

21 "The argument is plausible," runs the opinion, "but it is unsound. Assuming that experience has demonstrated what is claimed, the defendants undertook to repair their injured rails. They had the choice of repairing them on the common anvil or on the complainant's machine. By selecting the latter, they saved a large part of what they must have expended in the use of the former. To that extent they had a positive advantage, growing out of their invasion of the complainant's patent. If their general business was unprofitable, it was the less so in consequence of their use of the plaintiff's property. They gained, therefore, to the extent that they saved themselves from loss. In settling an account between a patentee and an infringer of the patent, the question is, not what profits the latter has made in his business, or from his manner of conducting it, but what advantage has he derived from his use of the patented invention" (94 U. S. 710).

similar results. In the words of a learned judge the economic principle is stated most concisely: "The fruits of that advantage are his profits."[22]

These simple rules for determining the profits of invention have made it clear that in at least one class of cases, the profits of efficiency have been frequently separated from the unearned surpluses of goodwill and monopoly. Now it is obvious that if proper provisions were made in the patent law, the rule so applied here might be extended to other instances. Without considering the ethical phase of the question, if public policy demanded such a differentiation for the purpose of giving to the state the unearned speculative profits of patent monopolies, the same distinction could be made between such returns in a large number of cases, or in any legally protected industry. Courts of law are determining every day the profits of businesses according to the well established rules of a political economy which are peculiar to their procedure; and the gains from differential advantages, goodwill, and monopoly are not new concepts to them, nor even ideas clothed in new terminology. That is to say, upon purely scientific grounds, the surpluses of monopoly and coercive restraint of trade may be made to stand apart from the proper rewards of dynamic efficiency.

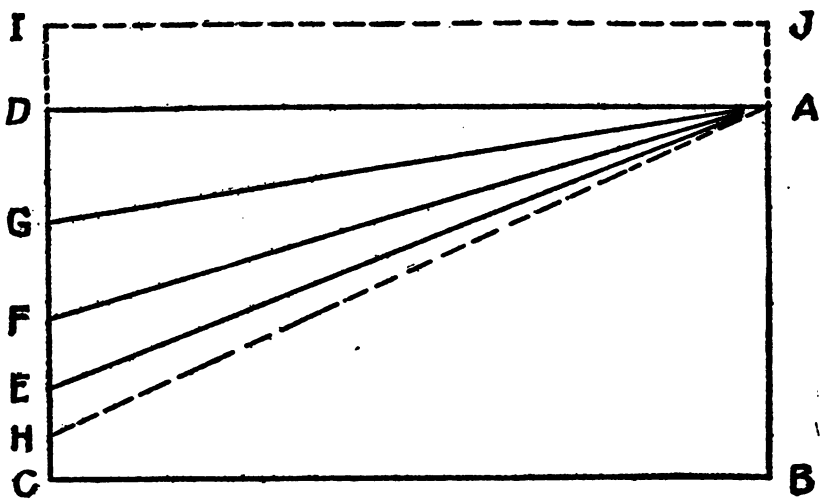
Let us turn now to a third class of negative utility gains which are defined here as subjective risk profits. In practice this increment is being gradually recognized by both jurists and economists. But so far, this study of efficiency profits has been naturally obscured by the existence of a peculiar risk cost; for a mental sacrifice appears concomitant with the rise and decline of every productive process. Every new method is an experiment, and is usually accompanied by some anxiety. In fact, the original risk is so great that the fate of an entire enterprise often hangs in the balance. We have noted in previous cases that despite the use of patented processes several enterprises operated at a loss. After long tests, many patents are found to be commercially worthless, bringing naught but anxiety and loss to the inventor. If in the course of time, however, a process is firmly established, this mental strain gradually disappears, though some risk losses still continue. Again, as a single enterprise declines in

[22] See *Suffolk Co.* v. *Hayden,* 3 Wall 320; *Brickill* v. *Mayor of New York,* 112 Fed. Rep. 71; *Mowry* v. *Higgins,* 43 Fed. Rep. 675.

efficiency or is distanced by more successful competitors, this risk burden reappears and the entrepreneur's worry increases in proportion to the risks taken and the amount at stake. Obviously his compensation for carrying risk losses and this *mental burden* must increase as his business grows less efficient. The common practice of balancing the gains of one class of commodities against the losses of another conceals the source of important risks, but where risks and losses are fully recognized the mental stress of fear and anxiety tends to limit supply until prices rise ultimately to the necessary cost level. Now it is to be noted that as the more efficient entrepreneur reduces these risk losses and the accompanying worry and anxiety, he secures two additional risk profits. There is, first of all, a gain from the increment necessary to compensate producers generally for undergoing the mental stress concomitant with risk. Indeed, the risks and anxiety common to all of the enterprises of a single kind limit to some extent the number of producers to be found therein. Consequently, by reducing in a single enterprise such industrial hazards and the accompanying mental strain, the usual or common compensation for the latter becomes in this case a profit of efficiency. This is the first form of subjective risk profit. Finally, his second gain from this source is somewhat different. Doubtless one would admit that the decrease in worry and care would permit the entrepreneur to give more attention to the dynamic function or the improvement of a definite industry. There is, then, a second gain from the increase in time, energy, and improvements made possible by the elimination of mental stress in particular enterprises. In other words, by way of contrast, risk losses and mental strain decrease for the more efficient entrepreneur; while risk costs as well as losses and the mental burden increase in the declining enterprises, and form a substantial basis for the marginal entrepreneur's economic sacrifice and, therefore, of minimum profits.

The general plan of profits presented here may be illustrated by the accompanying figure. Passing from right to left, the rectangle *ABCD* may be taken to indicate the varying expenses and efficiency profits of production in a group of competing industries from the marginal producer at *A* to the most efficient entrepreneur at *EC*. Beginning at *A*, the increasing sums going to wages of management of the more productive entrepreneurs may be represented comparatively by the triangle *AEF*. Stated con-

cisely, such wages are measured approximately by what the entrepreneur could get by entering the employment of some other person in the same industry. Wages of management do not, therefore, in a narrow sense include risk profits. Subjective risk profits, however, enter largely into minimum return profits. And as any minimum profit which the entrepreneur will accept and still remain in the industry will, therefore, be something more than mere wages of management, it may be represented by the two increments in the larger triangle *AEG*. If the entrepreneur did not manage his own business, his net profit would not, of course, include such wages. As each entrepreneur receives a differential minimum profit, according to the amount necessary to retain him permanently in the industry, such returns have been arranged here in an ascending scale from *A* to *G*. But the profit necessary to induce an entrepreneur to enter or to improve an enterprise must be something more than that necessary to retain him after he has become firmly established in it. True, men are usually attracted to a new field largely by prospective profits; but under freely competitive conditions, differential returns will



finally be determined by the plane of competition represented here by *AD*. Consequently, in a static industry, these become gains of efficiency measured approximately by *AFD*. And, as such utility profits are absolutely necessary to induce entrepreneurs to assume added investments, they become costs of production. So im-

portant are these in establishing theoretically the competitive plane and the demarcation of earned and unearned increments that this diagram may be taken as representing a detailed analysis of them as they occur in a static state.

The competitive plane thus becomes the natural line of division between the cost of production and the scarcity surplus; and there is added proof here that efficiency profits become costs of production. For example, every successful entrepreneur tends to expand outlays and output until his intensive margin of production coincides theoretically with this line; the latter becomes, therefore, a uniform plane of marginal costs. Clearly enough, it represents the normal level of competition between enterprises, the natural price of the English classical economists, and the cost price of the English common law. By tracing it again in theory, law, and industry, as the natural division between the profits of efficiency and the scarcity surplus, the first step is taken in differentiating the unearned increments of contractual restraint upon trade, monopolized advantages, and exploitative enterprises. Such increments are represented by the rectangle *ADIJ*. They are usually scarcity surpluses which accumulate by equal accretions upon individual units of product to pass finally to the landlord as contractual rents. The latter are indicated in this figure by the triangle *AEH*, as rent expenses of production. There is room in economic theory for both the scarcity and the productivity concepts of rent, but in this article we are interested mainly in the relation of scarcity rents to the plane of competition.

That the earned increments of the entrepreneur may finally be distinguished from his other incomes, the previous analysis of profits has made prominent the exact nature of efficiency returns. Such profits of efficiency are largely the reward of energies confined to the dynamic field and are equal to the net output measured in terms of marginal cost. During a long period of falling prices, they are determined by the difference between his own expenses per unit of product and those of the marginal entrepreneur in the same vicinity. Obviously, the undertaker's unearned gains are what he receives in the residual surplus above wages and the profits of efficiency.

It is therefore plain that between the English classical theory and the modern surplus concept of profits, between the internal and external economies of production, and between the efficiency and speculative profits of enterprise, may be drawn a line which

will differentiate the earned from the unearned incomes of the entrepreneur. This demarcation is of great importance in attacking intelligently modern economic questions; for it is plain that on one side are to be included positive utility, and the three forms of negative utility, profits; while beyond this line lie the speculative, monopoly, and exploitative increments, which have made these problems of such great interest to the entrepreneur.

Now the relation of the state to these various increments makes the demarcation still more important. Through the expenditure of vast sums, the state endeavors to aid the entrepreneur in production that he may secure greater utility profits. In the use of somewhat smaller sums, it seeks to protect and preserve the output, eliminate internal risk losses, and thereby increase risk profits. By means of various bulletins and reports, it attempts to conserve the external risk gains by aiding the producer to correlate his supply to demand. But beyond this line of demarcation the state ceases to lend the entrepreneur its assistance; its position, in fact, is suddenly reversed, for the well known speculative, monopoly, and rent increments are not to be encouraged by legislation. It would appear that its duty to the consumer lies rather in furthering as far as possible their elimination. Contrasted in other words, the state suppresses monopoly gains by legalizing the efficiency profits of certain coöperative combinations that preserve competition. It seeks to reduce the rent increments of the highly populated districts by encouraging greater production and higher utility profits in other sections. It passes laws to do away with the surpluses of speculation; and endeavors to prevent restraint of trade that the innocent investor and the original producer may not suffer discouraging risk losses but receive proper efficiency rewards for their efforts. Finally, on this competitive line of demarcation between the earned and the unearned increments is to be fought out, with more or less persistence, one of the greatest struggles of the industrial world.

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LEGAL PROFITS OF EFFICIENCY.

In a preceding article in this magazine, the labor and value concepts of profit were selected as the most important theories of the entrepreneur's income in the fields of both law and economics. The first explains profit as primarily a return for effort, exertion or labor on the part of the entrepeneur. This is above all an efficiency or labor theory. The second traces the origin of profit solely to certain dynamic changes in modern industry, and is clearly a scarcity or pure value theory. These two concepts represent, then, wholly unlike incomes. The first is an earned return; the second is plainly unearned. The state should continue to encourage the growth of the first; it should eliminate as far as possible the second. The legal competitive principle of the common law served to reduce unearned gains; but the plane of competition is fast losing its hold in modern decisions, and what was bold exploitation in former times may have become legitimate production of to-day. That the permanent position of efficiency profits in the common law may be emphasized in relation to the uncertain scarcity surpluses and that the function of the legal competitive principle in reducing unearned increments may be duly stressed, it seems best to examine with care the actual efficiency returns of the entrepreneur in the industrial world.

All returns of productive effort or exertion on the part of the entrepreneur may be classed as different rewards of efficiency; and the profits from this efficiency arise wholly in reducing the costs or sacrifices of production. In another place, such rewards have been classified by the present writer as positive and negative utility profits.[1] Positive utility profits appear in the creation of

[1]American Economic Review June, 1918.

added utilities through an increase in the positive forces of production. This utility may be measured—according to the nature of the entrepreneur's sacrifice—by an increment added to the output or by one taken from the total outlay which was not previously made for protective purposes. Negative utility profits, on the other hand, are due mainly to the entrepreneur's success in the protection of his product from certain negative elements which tend to reduce the total output. For example, all protective measures used for the preservation of the physical properties of the output or of the process itself tend to yield negative utility profits.

A proper treatment of the numerous forms of legal efficiency incomes, as we would differentiate them, should be introduced by a definite plan of profit analysis; and it will serve our purpose sufficiently well if at this point a tentative classification of the efficiency surplus is presented with due regard for its various subheads:

Efficiency profits which constitute a true earned surplus.

- A. Positive returns
  - I. Utility profits.
  - II. Wages of management.
- B. Negative returns
  - III. Subjective risk profits.
  - IV. Internal risk profits.
  - V. External risk profits.

A strong contrast may be drawn here between positive utility, and negative utility returns. Positive utility profits have their origin in the production of added salable commodities at the prevailing price, while a large part of negative utility profits is the result of merely preserving or redeeming such utilities from threatened loss or disuse. In the first place, the entrepreneur may, of course, reduce the costs of production or enlarge the capacity of the technical processes and finally the output of an industry. His efforts result largely in a relative increase of desirable utilities, mainly through an increase in the creative or positive forces of production. In any successful undertaking, these forces augment, then, the concrete utilities and the residual surplus of the entrepreneur; and that part of the output which is thereby added is, therefore, described as the positive returns of utility.

These are divided here into two subclasses. The simple profits of utility, which come first in our analysis, accrue from certain

dynamic changes in industry which may be traced directly to the inventive capacity and the coordinating powers of the entrepreneur. Wages of management, noted here as the second subclass, are usually derived from the positive returns of utility; and these arise in turn from efficient methods of directing or controlling the routine conduct of an industry. For example, the manager of an irrigation plant may succeed in augmenting positive utility returns by bringing new areas under cultivation; but as a means of protecting a fire-stricken section, this same plant may yield only negative utility profits. In the latter case, wages of management are also derived finally from the positive profits of utility which have been saved from destruction. Clearly enough, positive profits of utility constitute a much desired key to any careful analysis of efficiency profits.

On the other hand, the entrepreneur may be content to add to an established process only those services which reduce subjective, technical and market risks, and thus serve merely to preserve the present elements of production and the normal output of an enterprise. Obviously, such measures ward off injurious forces and give rise to three forms of negative returns.

Subjective risk profits, which form the first subclass, are due to the elimination of anxiety or any mental stress arising from the risk-taking function of the entrepreneur. After long tests, many enterprises are found to be practically worthless commercially, bringing naught but anxiety and loss to the entrepreneur. If in the course of time, however, a process is firmly established, this mental strain gradually disappears, though some risk losses still continue. In general if risk losses are fully recognized, the mental stress of fear and anxiety tends to limit supply until prices rise ultimately to the necessary cost level. Now it is to be noted that as the more efficient entrepreneurs reduce their risk losses and the accompanying worry and anxiety, they secure two forms of subjective risk profits. There is, first of all, a gain from the increment necessary to compensate producers generally for undergoing the mental stress concomitant with risk. Consequently, by reducing in a single enterprise such industrial hazards and the accompanying mental strain, the usual or common compensation for the latter becomes in this case a profit of efficiency. This is the first form of subjective risk profit. Finally, his second gain from this source is due to a saving in time, energy, and improvements made possible by the elimination of mental stress in partic-

ular enterprises. In other words, risk losses and mental strain decrease simultaneously for the more efficient entrepreneur; while costs, as well as the losses and the mental burden, increase for the less skillful producer, and form a substantial cause for the failure of the marginal entrepreneur.

The second group of negative returns, which are designated here as internal risk profits, comes from reducing the losses of certain internal economies of production. All protective measures used for the preservation of the physical properties of the output or the technical process itself are to be counted as internal economies, and this particular group of negative utility profits arises from efforts which preserve the concrete product and prevent its destruction or deterioration. Thus thick walls preserve the ice contained in the refrigerator car; and the ice in turn preserves the fruit or meat placed therein. Orchards in Colorado are often smudged to prevent frequent losses from heavy frosts. In like manner farm and mine owners are called upon to protect the elements of the earth. It is plain that a fisherman, who is able by a new device to prevent the total destruction of large quantities of fish, is thereby adding a considerable sum to his profits. Again, efforts have recently been made to protect crops from the ravages of insects and stock from sudden epidemic. The outlays required in such measures as spraying grain stored in elevators or the dipping of cattle to kill insect pests are to be counted as sacrifices of production. In fact, these constitute a form of risk costs which overcome losses and therefore yield a risk profit. All outlays of this nature eliminate a negative force; and are obviously to be separated by careful analysis from those costs which increase the positive forces of production.

The third class of negative utility gains are external risk profits. These are obtained by overcoming losses in the external economies of production. That is to say, measures taken to prevent the fluctuation of money costs in outlays or to secure a permanent market for finished goods generally decrease risk losses. It will thus be seen that external risk profits are of two distinct kinds, and that they depend directly upon overcoming the speculative elements in purchasing the factors of production and in selling the finished product. In many instances such losses are reduced by annual contracts which fix wages; by the importation of new laborers; by the purchase or lease of mineral, timbered, and ranch lands to secure raw products; and by establishing or purchasing enterprises supplying needed materials.

Obviously, such measures as we have described here ward off injurious forces, are preventive rather than constructive, tend to keep an enterprise from falling below the productive margin, serve to preserve concrete utilities, and consequently yield the entrepreneur different forms of negative utility gains. These various forms of concrete utility profits, protected as they are by the common law of the land, require careful and critical examination.

In this article our interest is centered mainly in the different forms of legal efficiency profits. Many instances may be selected in which scarcity returns are practically absent; and, indeed, a great variety of legal decisions affords us large opportunity of studying efficiency profits in detail. Throughout a long line of legal opinions runs the constant effort to restore to the injured person the thing for which he has bargained, to enforce the performance of contracts, or to render damages in return for the utility or economic good of which he has been deprived. These principles of compulsory co-operative effort governing a large group of modern cases, and especially the rule which excludes uncertain or contingent profits as a measure of damages furnishes for the investigator a wide field for the study of various forms of efficiency profits. Thus in any suit for damages arising from injury to one's business, it is usually stated by the court that the plaintiff should be allowed compensation for the *losses sustained* and the *gains prevented*. Clearly enough these are technical terms which distinguish between losses sustained in whole or part from the entrepreneur's expenditures, on the one side, and gains prevented because of his failure to secure a definite profit on the other. But though the meaning of each of these terms is fixed and definite they do not include the contingent and uncertain gains of the market. Even earned gains, which are still expectant rewards and subject to the fluctuation of market prices, are seldom included in the measure of damages. Whether such contingent profits are earned or unearned, they are excluded by the court from the evidence submitted to the jury; and it is clear that the constant evolution in the legal theory of damages is steadily compelling men to co-operate actively in furthering the means of production and the accumulation of efficiency returns. The fruit of every man's effort is thus, in one sense, guaranteed to him by the law of the land; and such profits of efficiency may be studied in relation to the legal remedies by which they are preserved.

I. Utility profit, then, as we have termed it, is the first form of efficiency return. That the entrepreneur shall rest secure in the rightful enjoyment of his output and the legitimate means of production is a well-established principle of the law. From ancient times this right has been constantly guarded by legal remedies.[2] It is therefore necessary to emphasize the important place which utility profits occupy in the socio-legal process. In fact, these profits form the keystone of all co-operative production; for to create value in use is the main object of the entrepreneur's function and of his co-operative efforts in the technical field. Moreover, upon the previous existence of positive utility profits depends the other forms of efficiency returns. We have, therefore, selected examples of utility profits from leading decisions in which this obligation to co-operate in the productive process is shown entirely independent of exchange value.

Thus, litigation arising between the owners of water rights illustrates simply a struggle for positive utility profits or the use value of the same stream. The right to the use of water pertains to the ownership of the land through which the stream naturally flows, and it is vested alike in every owner of the soil. If one person, by wrongfully diverting water from its course, works injury to another, he renders himself liable to some form of legal or equitable remedy, depending largely upon the nature of the case. Chancellor Kent has put this fact in a very concise form in his well-known Commentaries:

> "All that the law requires of the party, by or over whose land a stream passes, is, that he should use the water in a reasonable manner, and so as not to destroy, or render useless, or materially diminish, or affect the application of the water by the proprietors above or below on the stream. He must not shut the gates of his dams, and detain the water unreasonably, or let it off in unusual quantities, to the annoyance of his neighbor."[3]

[2]But in more modern decisions the idea of an earned or utility profit has been somewhat obscured by the recent evolution of contractual rights. Strangely enough, utility profits, which form an exact measure of the entrepreneur's effort, have, by virtue of this change, often become embodied in the larger and more complex "earnings" of the business. That is, the legal labor theory of utility profits and the "earnings" of the employer have been gradually overshadowed by the greater "earnings" of capital. But this is simply one result of the contractual amalgamation of the productive forces in social process.

[3]3 Kent, Comm., 440; See also Merritt *vs.* Brinkerhoff (1820) 17 Johns. 306; Tyler *vs.* Wilkinson (1827) 24 Fed. Cas. No. 14,312; Pollitt *vs.* Long (1870) 58 Barb. 34.

In a particular instance in New York, the defendant had unreasonably obstructed the flow of a stream and deliberately deprived the complainants of the use of their factory during several working hours of each day. The latter were not allowed to recover prospective money profits as damages, but they were entitled to the use value or utility of the water which had been withheld.

> "The true measure of damages in a case like this", said the court," is the value of the use of the water to the plaintiffs, situated as they were, during the time they were wrongfully deprived of it."[4]

Obviously, these excerpts contain a legal guaranty of compulsory co-operative effort among enterpreneurs on the same stream. It is abundantly plain that by unduly withholding water from other users, one person might decrease their utility profits; by suddenly flooding the stream he might increase their technical or internal risk losses. This form of legal compulsory co-operation tends, therefore, to give to each user of water the full benefit of his utility profits.

II. Wages of management or the earnings of the entrepreneur come second in our plan of analysis. Historically considered, the tendency to include profits within the rule of damages has crept into American law by degrees. This principle was undoubtedly first applied in early cases to the earnings of the laborer and the professional man, for the value of their services was estimated as profits. Somewhat later the rule was extended to the personal earnings of the entrepreneur, that it, the wages of superintendence and management. At the present time, however, these co-operative surpluses are considered as arising directly from the economic efforts of the entrepreneur in a gradually ascending scale from wages of management to the more or less certain earnings of an entire business. And there is now a well-established rule of law which allows him to recover compensation for injury to his personal powers of production or to the factors which he would have used in his business. In fine, the entrepreneur's personal effort becomes, then, the primary cause and measure of all efficiency profits.

Most noteworthy is the fact that in certain states wages of management have been constantly distinguished from the gains upon capital or the fluctuating surpluses of a commercial venture. Indeed, this policy of confining the rewards of personal manage-

[4]Pollitt *vs.* Long (1870) *supra*, footnote 3, at p. 36.

ment strictly to the earnings of the producer is of great significance. It has served to segregate these rewards from the more contingent surpluses, and the judges here have given us a remarkable series of legal data which include such earnings under the rule of personal damages. In this respect, the courts of no state have made more important additions to this modern theory than those of New York; they have at least plainly differentiated the economic results of this personal element in industry from the purely technical output and the speculative surpluses of capital. For example, in 1874 one member of a firm testified that he was engaged in the business of importing tea, that this part of the enterprise required great skill, and that as the consequence of an injury to himself his earnings had rapidly declined;[5] and in a later case in the same state, the plaintiff, who was engaged in the sale of dry-goods, claimed that because of a personal injury his profits had rapidly decreased.[6] But in neither of these instances did the court allow past profits upon capital to be taken as a measure of the earnings of the plaintiff. Nor is any intimation given that proof of the existence of past profits may be made to enable the jury to estimate what the future gains might be.

In this relation, moreover, the decisions of several states have been quite uniformly against the recognition of profits on capital. We may select, for example, an opinion of the Supreme Court of Michigan rendered in 1893. It was declared that the loss of profits in conducting an enterprise involving the labor of others is not considered to be a necessary consequence of personal injury to the plaintiff. The extent of one's recovery upon this ground would, in brief, be determined by what his services were worth in the conduct of the business in which he was engaged.[7] In the more recent suit of *Kronold* v. *City of New York*,[8] the court cited from a large number of decisions which rejected profits in making up the rule of damages for personal injury. These opinions were said, indeed, to be "all based upon facts which disclose such a preponderance of the business element over the personal equation, or such an admixture of the two, that the question of personal earnings could not be safely or properly segregated from returns", upon merely invested capital. Also, a year later, a court of this state excluded the profits of a lunch business for the same

[5] Masterson *vs.* Village of Mount Vernon (1874) 58 N. Y. 391, 395.

[6] Lincoln *vs.* Saratoga, *etc.*, R. R. (1840) 23 Wend. 425.

[7] Silsby *vs.* Michigan Car Co. (1893) 95 Mich. 204, 209; 54 N. W. 761.

[8] (1906) 186 N. Y. 44, 45, 78 N. E. 572.

reason. As a matter of fact, it was conceded that the business did not require a large capital or employ more than three men; but the issue in the case was said to involve expressly the total profits of a business and not merely the value of the entrepreneur's personal services.[9] Such profits were, therefore, not included in personal earnings. A like distinction is made by the courts of Pennsylvania. The net gain of an enterprise is said to depend largely upon other circumstances than the earning capacity of the person managing the business. The location of the town, the character of the business, the degree of competition, and the prosperity of the community are all to be considered as affecting profits.[10] Yet *per contra,* the profits of a real estate business have been taken as a measure of personal damages in this same state.[11] Strangely enough the court here seems to have followed a previous decision[12] in which the plaintiff—a peddler, was allowed to prove that his annual sales tended to show the returns that he might have earned had he been able to attend properly to his business.

> "We apprehend", said the court, "that the profits arising from a legitimate land business are not less certain than those arising from the business of peddling, nor more difficult to estimate."

In well-established businesses, moreover, it is apparent that the courts are inclined to construe this principle less strictly. The injured person is permitted to recover as compensation whatever profits it is reasonably certain he would otherwise have realized. A most illuminating, as well as a somewhat extreme, opinion is given in a case of Illinois.

> "We all know", declared the judge in giving this decision, "that in many, if not all, professions and callings, years of effort, skill and toil are necessary to establish a profitable business, and that when established it is worth more than capital. Can it then be said, that a party deprived of it has no remedy, and can recover nothing for its loss, when produced by another?" "And of what does this loss consist," continued the court, "but the profits that would have been made had the act not been performed by appellants?

[9]Weir *vs.* Union R. R. (1907) 188 N. Y. 416, 419; 81 N. E. 1178.

[10]Goodhart *vs.* Pennsylvania R. R. (1896) 177 Pa. 1, 15, 16, 35 Atl. 191.

[11]Pennsylvania R. R. *vs.* Dale (1874) 76 Pa. 47, 49.

[12]Hanover R. R. *vs.* Coyle (1867) 55 Pa. 396.

> And to measure such damages, the jury must have some basis for an estimate, and what more reasonable than to take the profits for a reasonable period next preceding the time when the injury was inflicted, leaving the other party to show, that by depression in trade, or other causes, they would have been less?"[13]

This opinion shows a marked divergence from those just considered. It referred particularly to a planing mill, the profits of which obviously arose, not so much from the personal earnings of the entrepreneur, as from the necessary use of machinery. In this respect, it is largely antagonistic to the spirit of the decisions of Michigan and New York.

III. Subjective risk profits. There seems to be little room in law for the collection of a subjective risk profit. Mental anguish arising from an injury to property has often been held not to be a subject of damages. This is undoubtedly the rule of many early cases. That is, unless the mental suffering resulted in connection with some personal physical injury it did not form a measure of compensation. Doubtless to become a basis of damages mental injury must be accompanied by definite and recognized physical effects. Nevertheless, a considerable collection of cases might be made in which successful actions were maintained to recover damages for mental stress in relation to the technical processes of production. Such decisions seem to furnish important exceptions to the preceding rule. Stated concisely, when the mental anguish is the natural and direct result of an injury to property or a breach of contract, compensation has not seldom been allowed for it. Now any injury to the productive process affects in most instances the accompanying risks and the corresponding worry over losses. Obviously, this interference may affect appreciably the entrepreneur's person, or the labor, land, and capital employed. On the other hand, if he learns to bear risks with fortitude, his mental suffering is decreased, his time and efforts yield greater rewards, and his subjective risk profits become efficiency returns.

A number of decisions which verify this view may be selected: Thus when a person was injured by the defendants through an illegal boycott, he was allowed to collect damages for his mental suffering.[14] In another instance the defendant had maliciously in-

[13] Chapman *vs.* Kirby (1868) 49 Ill. 213, 219.

[14] Carter *vs.* Oster (1908) 134 Mo. App. 146; 112 S. W. 995.

jured the horse of the plaintiff. It was held that the latter could recover damages for his injured feelings.[15] Practically the same decision was reached in Missouri in a case in which the defendant had wrongfully chastised the plaintiff's slave.[16] Also, in the subject of contracts, the more recent cases go far toward establishing the rule that when a breach of contract naturally involves mental suffering, compensation may be allowed for the pain. The Supreme Court of Tennessee has explained that

> "Where other than pecuniary benefits are contracted for, other than pecuniary standards will be applied in the ascertainment of the damages flowing from the breach."[17]

In harmony with this view, damages for mental suffering have been allowed by the courts when the plaintiff was wrongfully turned out of his leased house[18] or was expelled from a well-known amusement hall by the lessee[19] and when the defendant failed to furnish a trousseau for a certain bride[20] or to provide a proper furnace for a particular house.[21]

IV. Internal risk profits. The term "losses sustained" refers, as we have previously explained, to a measurable loss in the productive process. The injury inflicted falls upon the concrete services of labor, land or capital, and finally upon the finished output. The courts endeavor by means of the rule governing the rendering of damages to restore an enterprise to the condition in which it existed before the injury occurred. The transgressor, in other words, is made responsible for the internal risk losses which he has occasioned; and by this course the courts have overcome certain risk losses, restored the corresponding risk profits of the entrepreneur, and guaranteed to him the product of his own effort. It is therefore possible to take up through the rule of damages the legal method of measuring negative utility profits derived respectively from labor, land and capital.

(a) Internal risk profits on labor. The rule of damages

[15] Kimball *vs.* Holmes (1880) 60 N. H. 163, 164.

[16] West *vs.* Forest (1856) 22 Mo. 344.

[17] Wadsforth *vs.* Western Union Tel. Co. (1888) 86 Tenn. 695, 703; 8 S. W. 574.

[18] Moyer *vs.* Gordon (1887) 113 Ind. 282; 14 N. E. 476.

[19] Smith *vs.* Leo (1895) 92 Hun 242, 243; 36 N. Y. Supp. 949.

[20] Lewis *vs.* Holmes (1903) 109 La. 1030; 34 So. 66.

[21] Vogel *vs.* McAuliffe (1895) 18 R. I. 791; 31 Atl. 1.

secures to every employer the use value of his hired laborers. For example, a contractor by using dynamite in the vicinity of the plaintiff's factory, drove the latter's workmen temporarily from the building in which they were employed. It was held that the owner of the factory might recover the value of the workmen's time so lost. That is, the use value of each laborer was taken as a measure of damages. It was explained in this decision that

> "The measure of damages would be the value to the plaintiffs of the work which the defendant's negligence prevented from being done."[22]

A right to the prospective use value of all laborers employed in any particular enterprise is shown in cases in which the workmen of one employer are enticed away by another. Thus, the act of inducing servants to leave the service of their master seems from an early period to have been held a serious wrong in English law. Blackstone condemns the peculiar grievance in no uncertain language.[23] In a leading English case, the injury complained of was perpetrated by persons who had invited the entrepreneur's laborers to dinner and had then induced them to leave his employ. It was claimed by the latter that through this act, he had lost the profits for two years upon the manufacture of his pianos. As often happens, the laborers in this instance worked by the piece and were not hired for any definite period. Wages were not, however, taken as the measure of damages; but on the contrary, the prospective profits upon the final product for two years were accepted as the standard of compensation. Indeed, such profits were not looked upon by the court as too remote or uncertain. Under this ruling, it is plain that the use value, not only of labor but of all the factors used in production, was indicated by the profits to be obtained.[24] But after all, this final standard can only be used when it is regarded by the courts as reasonably certain. Thus the decision was otherwise when the profits were expected from a singer's somewhat uncertain performance. Returns in this last instance were not sufficiently definite to be recovered by the lessee of an opera house who had been deprived of its use.[25] Moreover, the injury suffered by a well-known singer

[22]Hunter *vs.* Farren (1879) 127 Mass. 481, 484.

[23]3 Comm. 143.

[24]Gunter *vs.* Astor (1819) 4 Moore 12.

[25]New York Academy of Music *vs.* Hackett (1858 N. Y.) 2 Hilt. 217.

from the low temperature of an unfinished opera house and damages claimed were of necessity purely speculative and conjectural.[26] Also, in *Smith* v. *Goodman*[27] certain laborers had been imported by the plaintiffs into Georgia expressly for the purpose of using them on a turpentine farm. After working about three days, they were induced to enter the employment of another person; and the latter willfully retained them during the period for which they had previously been hired. The circumstances attending the infliction of the injury were of a very aggravating nature, for the plaintiffs had been put to considerable expense and trouble in obtaining the workmen.

> "They proved their loss", said the court, "by showing what would have been the net profits of each of these laborers, and what they had lost by the failure to improve their property in consequence of the decoying and retaining of these servants by the defendant and his coadjutors."

(b) Internal risk profits on land or natural agents. The entrepreneur is also entitled to the use value of the natural agents which he employs in any thoroughly established process of production. The jury is allowed, however, to use considerable discretion in arriving at the value of this use. Whether profits are allowed as damages depends somewhat upon the nature of the business affected by the injury. Profits have been found sufficiently reliable to be made a measure of damages in agriculture, grazing, and some forms of mining. But on the other hand, where land is used mostly for commercial purposes or as a means of obtaining mineral wealth, the courts have shown a marked reluctance in permitting profits to be made a final rule of compensation for injury to property.

Of the various uses to which land is devoted, profits seem to be regarded as most reliable in agricultural pursuits. By way of illustration, a railroad company in Oregon raised an embankment which cut off a farmer's access to the river on which he had long carried his products to market. The supreme court held that the company became liable to him for the exact profits of which he had been deprived.[28] In another decision it was explained that in general if the owner of land is wrongfully prevented from oc-

[26] *Ibid*, pp. 222, 223.

[27] (1886) 75 Ga. 198, 201, 202.

[28] Willer *vs.* Oregon Ry. (1887) 15 Ore. 152, 156; 13 Pac. 768.

cupying it, the measure of his damages is the value of the use of the land,—that is, its rental value. In that case the plaintiff's farming land was wrongfully overflowed before crops had been planted on it; the measure of damages was held to be the fair rental value of the ground but not of the value of the crops that might have been raised on it.[29] The court was careful here to exclude the value of the future product which might have been obtained from the land. The value of growing crops, however, has in many cases been given to the jury in making up a just compensation for damages incurred. Certain it is, that the value of agricultural products, even of those not yet matured, seems to have gained a permanent foothold in the legal rule of damages.[30] But it is to be noted that as we enter the commercial field, this rule becomes more variable. In two specific cases access to a person's land was effectually obstructed, but he could not legally recover the profits that he might have made by selling clay from it[31] or by disposing of the land itself.[32]

However in certain states the important place which land occupies in fixing the measure of damages is seen in its use even for commercial purposes. In Indiana one person leased from another a candy stand at a county fair on condition that no competitors were to be allowed within certain limits. The lessor broke his contract by leasing a part of the premises to another enterprise. It was decided that the prospective profits which might have been made in this instance but for the presence of competition, were too uncertain. However, the measure of damages finally accepted by the court was the difference between the rented value of the premises with and without the rival stands.[33] But it will be found upon reflection that as the rental value of building sites depends especially upon the social demand for them, here strangely enough, the use value is made to vary directly with a fluctuating demand and depends, therefore, in a peculiar manner upon the money income of a business. That is to say, in the case of personal effort, as we have seen, wages are used only as a

[29]City of Chicago *vs.* Huenerbein (1877) 85 Ill. 594; See Baldwin *vs.* Calkins (1833) 10 Wend. 169, 175, 179.

[30]The Chicago *vs.* Ward (1855) 16 Ill. 522; Drake *vs.* The Chicago etc. Ry. (1884) 63 Iowa 302, 310; 19 N. W. 215; Easterbook *vs.* Erie Ry. (1865) 51 Barb. 94; Chase *vs.* New York Central R. R. (1857) 24 Barb. 274, 275.

[31]Garritee *vs.* City of Baltimore (1879) 53 Md. 422.

[32]San Antonio *vs.* Mullaly (1895) 11 Tex. Civ. App. 596, 599.

[33]Montgomery County Union Agricultural Society *vs.* Harwood (1891) 126 Ind. 440; 26 N. E. 182.

means of determining the rule of compensation; but the unearned rental value of land, on the other hand, seems to be taken as an exact measure of damages. There is some deviation from this rule, however. In a second instance, the defendant had so obstructed a river that the injured person had lost considerable patronage at his hotel which was situated on the bank of the stream. This form of business borders, of course, on the commercial field; consequently, the court found that the proprietor could recover compensation for the damage which he had suffered in the loss of business profits.[34] And it is more than probable here that the proprietor's total profits exceeded somewhat the rental value of his property.

In like manner the use value or profit is taken as the measure of injury to other forms of natural agents. For example, the tollage or reasonable value of a stream for floating logs may be recovered as compensation from a person who has obstructed it.[35] In another instance, the plaintiff's loss by the diversion of water from both his mill and farm amounted to over one hundred dollars a year, which was allowed as the measure of damages by the jury in the case.[36] In Rhode Island the water wheel of a cotton mill was impeded by the overflow of water from the erection of a dam farther down the same stream. In assessing the plaintiff's damages, he was allowed

> "to show the additional quantity of goods which the mill was capable of making, and probably would have made, had the wheel been unobstructed by the dam, the value of those goods when made, the cost of making, and the prices which such goods brought in the market, during the time; thus showing the general profit of the business which the plaintiff carried on."[37]

Similar damages were collected for the pollution of a pond. This act had destroyed the ice supply of a well-established business.[38] Of the same character were other decisions which allowed com-

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[34]French *vs.* Connecticut River Lumber Co. (1887) 145 Mass. 261; 14 N. E. 113.

[35]DeCamp *vs.* Bullard (1899) 159 N. Y. 450, 452, 455; 54 N. E. 26.

[36]Washington County Water Co. *vs.* Garver (1896) 91 Md. 398; 46 Atl. 979.

[37]Simmons *vs.* Brown and Wife (1858) 5 R. I. 299, 301, 302; See also Gibson and Kloppenstein *vs.* Fischer and Orton (1885) 68 Iowa 29; 25 N. W. 914.

[38]Lawton *vs.* Herrick (1910) 83 Conn. 417; 76 Atl. 986.

pensation for the carrying away of ice from various mill ponds.[39] Thus, in the state of Connecticut such ice belongs to the owner of any overflowed land, subject to the right of the mill owner if it be necessary to maintain a proper supply of water for his mill.[40] Where a mill dam in Massachusetts was destroyed, damages were assessed for the cost of repairing the dam, and also for the interruption of the use of the mill and the diminution of profits by diversion of the water.[41] Again, this use value, or its measure in the form of profit, has been allowed as damages for withholding the water of a stream rightfully used in running a mill.[42] Likewise, where the defendant by means of an injunction maliciously prevented the plaintiff from using his own coal lands for a year, it was held that, not only the nature and extent of the coal beds, but also the profit on possible sales of coal might be shown,

> "not in order to be allowed by the jury 'as profits', but to be treated as one of a mass of facts that throws light upon the value of the use of the rights taken from Upson."[43]

And where the plaintiff was excluded from the use of his mine, he was not allowed to recover prospective profits, but to show simply the amount of his actual loss, that is, what the use of the premises was reasonably worth. However, the fact that before and after the period in question "the mine was productive and profitable", was taken as showing with sufficient certainty a definite loss of profits by the plaintiff.[44] But in other cases the profits of mining have been held too uncertain to be recovered as a measure of damages.[45]

(c) Internal risk profits on capital. The legal principle which permits the courts to allow compensation for damages applies as a matter of course to all capital which has been incorporated in a thoroughly established business. The entrepreneur is entitled as might be expected, to the use value of the instruments of produc-

[39] Mill River Woolen Mfg. Co. *vs.* Smith (1867) 34 Conn. 462; Howe *vs.* Andrews (1892) 62 Conn. 400; 26 Atl. 394.

[40] Geer *vs.* Rockwell (1895) 65 Conn. 323; 32 Atl. 924.

[41] White *vs.* Moseley (1829) 25 Mass. 356.

[42] Pollitt *vs.* Long (1870) 58 Barb. 20, 34; Woodin *vs.* Wentworth (1885) 57 Mich. 278; 23 N. W. 813.

[43] Newark Coal Co. *vs.* Upson (1883) 40 Oh. St. 17, 26.

[44] Moffatt *vs.* Fisher (1877) 47 Iowa 473.

[45] Coosaw Mining Co. *vs.* Carolina Mining Co. (C. C. 1896) 75 Fed. 860; McCornick vs. United States Mining Co. (C. C. A. 1911) 185 Fed. 748.

tion both in manufacturing and in trade and commerce. But the measure of damages here seems to be more complicated than in the case of land. The standard of compensation may refer to a single unit of capital, a group of related factors, or to an entire business. If the injury complained of affects an entire enterprise, its use value is usually taken as the criterion of damages. Still the money profits of an enterprise are often fixed and certain, and they may then be taken as the final standard of this use value, but much less frequently in trade and commerce than in manufacturing. We may take first the simple application of this principle in the milling industry. In one instance the erection of a mill was wrongfully delayed. The prospective rent of the completed mill was taken as the measure of its value in use; but the court refused to consider future profits as the standard of compensation.[46] Nor in the case of failure to erect a mill on a certain person's land could the latter recover as damages the profits from the proposed business.[47] But where a person had agreed to repair a long-established mill and had failed to keep his contract, the miller was able to recover the money profit that he would have made by sawing the logs already secured for manufacture into lumber.[48]

Certain it is, that the circumstances under which this rule is applied in manufacturing afford a wide field of investigation for the economist. Within this range of subjects, we may note that damages were obtained by injured persons for the destruction of the stock, of a green house,[49] for failure to keep buildings in repair,[50] for injury caused by supplying poisonous coloring matter to an ice cream factory,[51] for interrupting a fibre mill by raising the water of a stream,[52] and for disabling an engine necessary to carry on a certain business.[53] This rule applies, of course, where the profit-

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[46]Abbott *vs.* Gatch (1858) 13 Md. 314.

[47]Jones *vs.* Nathrop (1883) 7 Colo. 1; 1 Pac. 435.

[48]Hinckley *vs.* Beckwith (1860) 13 Wis. 34; *contra* see Martin *vs.* Deetz (1894) 102 Cal. 55; 36 Pac. 368.

[49]Laufer *vs.* Boynton Furnace Co. (1895) 84 Hun 311; 32 N. Y. Sup. 362.

[50]Raynor *vs.* Valentin Blatz Brewing Co. (1898) 100 Wis. 414; 76 N. W. 343.

[51]Swain *vs.* Schieffelin (1890) 58 Hun 608; 12 N. Y. Supp. 155.

[52]Fibre Co. *vs.* Electric Co. (1901) 95 Me. 318; 49 Atl. 1095.

[53]Wolff Shirt Co. *vs.* Frankenthal (1902) 96 Mo. App. 307; 70 S. W. 378.

able use of premises is prevented by a failure to supply necessary machinery or power.[54] When the operation of a mill was delayed because a steam engine was not furnished according to contract, the loss of the use of the mill was held to be properly included in damages.[55] In a unique case the plaintiff intended to use a machine ordered by him for a peculiar and novel purpose. He accordingly presented a claim for damages commensurate with the large profits which he expected from the intended use. But the court held, on the contrary, that the measure of damages was the value of the use of the machine for the ordinary purpose for which it was constructed. Clearly enough the plaintiff could not claim profits upon experiment, but strange to say he was allowed such gains from a use to which the instrument was not devoted.[56]

It is to be observed, however, that this rule is somewhat modified in its application to newly established industries. If the entrepreneur embarks upon a new business venture, he can recover nothing as damages from his expected profits. His profits are very uncertain, and, as one court has said, there may be either a profit or a loss. The enterprise has not yet proved its worth; and actions for damages are confined to a consideration of the actual use value of the enterprise.[57] Moreover, it may be added that this rule also applies strictly to those parts of an established enterprise, which are intended to serve wholly a new use.[58]

Even the use value of single capital units is rejected in making up the measure of damages, if by some means they are wholly destroyed. That is to say, actions brought for the entire destruction of profits do not involve any question of "gains prevented"; for the law assumes that the plaintiff's interest in the destroyed property ceased and was replaced by the right to secure its value in money. To be more explicit, the owner of a machine may obtain

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[54]W. P. Callahan & Co. *vs.* Chickasha Cotton Oil Co. (1906) 17 Okla. 544; 87 Pac. 331.

[55]Freeman *vs.* Clute (1847) 3 Barb. 424; Davis *vs.* Talcott (1853) 14 Barb. 611, 628.

[56]Cory *vs.* Thames Iron Works Co. (1868) L. R. 3 Q. B. 181, 17 L. T. R. (N. S.) 495.

[57]Central Coal Co. *vs.* Hartman (C. C. A. 1901) 111 Fed. 96; Red *vs.* Augusta (1857) 25 Ga. 386; Kenny *vs.* Collier (1887) 79 Ga. 743; Green *vs.* Williams (1867) 45 Ill. 206; Hair *vs.* Barnes (1887) 26 Ill. App. 580; States *vs.* Durkin (1902) 65 Kan. 101; 68 Pac. 1091; First Nat. Bank *vs.* Carroll (1907) 35 Mont. 302; 88 Pac. 1012.

[58]Red *vs.* Augusta, *supra*; Kenny *vs.* Collier, *supra*; Coweta Falls Mfg. Co. *vs.* Rogers (1856) 19 Ga. 416; Crabbs *vs.* Koontz (1888) 69 Md. 59; 13 Atl. 591.

damages for delay or partial destruction because of his loss of the use of it;[59] but if it is wholly destroyed, he is allowed to receive the entire value of the machine; but no compensation except interest is given for the time during which he is deprived of its services. He is no longer able to claim that he might make a future gain by means of it, and his recovery is, therefore, limited to the value of the property at the time of its destruction.[60] This is true both of natural agents and capital.

The most perplexing problems in the application of this rule occur, needless to say, in the cases which involve transactions in trade and commerce. Without doubt the courts attempt to carry out where possible, the age-long principle of basing damages upon use value; but the conditions under which it is applied make the rule necessarily somewhat flexible. A court in Minnesota has even declared that cases rarely occur in which profits in a mercantile business are sufficiently certain to be used as the basis of a rule of damages.[61] But this opinion is, perhaps, too radical, for at all events it does not seem to agree with the trend of the most recent opinions. In a number of such cases, at least, the courts have accepted money profits as the final standard of compensation. In a particular instance, a plaintiff, while engaged in the messenger business, had rented a telephone which he expected to use for a year. The instrument was, however, taken out so that he lost the use of it for nine months. Although the business had been carried on only a short time, the evidence showed that it was increasing; and the jury was, therefore, instructed to assume that the increase would continue. Despite the fact that profits were not absolutely certain, the court was of the opinion that such prospective returns had been under consideration when the contract was made. It was, therefore, held that the plaintiff might recover for his loss of profits during the remainder of the contract period.[62] Further, in a Massachusetts case the injured person was allowed to show that during the time he was furnished with trading stamps by the defendant, his business had perceptibly increased, and that when they were no longer

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[59]Thomas B. & W. Mfg. Co. *vs.* Wabash, *etc.* Ry. (1885) 62 Wis. 642; 22 N. W. 827; See Edwards *vs.* Beebe (1865) 48 Barb. 106.

[60]This is true both of natural agents and capital. McKnight *vs.* Ratcliff (1863) 44 Pa. 156, 169; Erie C. I. W. *vs.* Barber (1884) 106 Pa. 125, 135.

[61]Casper *vs.* Klippen (1895) 61 Minn. 353; 63 N. W. 737.

[62]Owensboro Telephone Co. *vs.* Wisdom (1901) 23 Ky. Law Rep. 97.

supplied, it showed a sudden decline.[63] The Supreme Court of Michigan has decided that in cases of this sort the measure of damages is, not the expected profits, but the average value of the use of the property employed. To ascertain this use value, evidence has been admitted of the actual existence of past profits.[64]

Finally, in the field of trade[65] and commerce we are deeply interested in two classes of cases which serve to compel the seller to co-operate with the purchaser of an economic good if the latter is used in carrying on a productive process. In the first class of cases, there is an implied agreement from the circumstances under which the sale is made that a commodity furnished by the seller shall not prove defective or unsound. In the second class of decisions, he simply fails to deliver the goods at the time prescribed in his contract. This act may, of course, work a definite injury to the purchaser, and the court will generally order a performance of the contract, or award him damages according to his injury.

In the first group of cases, the seller becomes responsible by an implied contract for the quality of the good which he furnishes. We shall examine a few cases by which this right is sustained. In early cases under the civil law, there is an implied warranty on the part of the seller that he possessed a valid title to the goods which he offered, and that they were not defective. But under the common law there is a clear distinction between the warranty covering the title and that relating to the quality or use value of a good. The title was warranted under the common law; but if the purchaser had opportunity to examine the good, the seller

[63] Gagnon *vs.* Sperry & Hutchinson Co. (1910) 206 Mass. 547, 555; 92 N. E. 761.

[64] John Hutchinson Mfg. Co. *vs.* Pinch (1892) 91 Mich. 156, 160; 51 N. W. 930. On the other hand, where a river boat in New York lost a trip on account of a collision with another vessel, it was held that the profits were too speculative to be recovered. Hunt *vs.* Hoboken Land Imp. Co. (1854) 3 E. D. Smith (N. Y.) 144. This opinion is, of course, based upon the evidence of a particular case. It is to be observed, however, that the ruling, as such, is hardly in harmony with the decisions of other states.

[65] Suits for damages in the field of trade are numerous. Actions have been successfully maintained for interference with an established jewelry business after the entrepreneur was evicted by the landlord Allison *vs.* Chandler (1863) 11 Mich. 542; for interrupting in like manner the business of a broker, Kitchen Bros. Hotel Co. *v.* Philkin (1902) 96 N. W. 487, for ejecting a tenant from premises which he had used as a skating rink, Standard Amusement and Mfg. Co. *vs.* Champion (1909) 76 N. J. L. 771; 72 Atl. 92, and for guaranteeing that a railroad would enter the town in which an enterpriser was induced to set up in business, Arkansas Valley Town & Land Co. *vs.* Lincoln (1895) 56 Kan. 145; 42 Pac. 706.

was not held responsible for its quality. As American courts have followed the common law principle, the purchaser is required to examine such commodities, and to take them at his own risk in so far as he can rely upon his own observation and judgment. But it is to be noted that, as an important exception to the rule, an *implied* warranty may arise from the circumstances under which a sale is made. This exception is, at this point, of great economic significance.[66]

In a leading case upon this subject[67] it was said that the damage recoverable for a breach of contract might be considered as arising naturally in the usual course of things from the failure to keep it. And it was stated explicitly that when the special circumstances under which a contract is made are communicated to each party, damages may be recovered according to the injury which would ordinarily follow from a breach of it. Thus in the English case of *Curtis* v. *Hannay,*[68] Lord Elden declared that if a person purchase a horse which, though warranted, turns out to be unsound at the time of the sale, the buyer might keep it, if he pleased, and recover the difference between the value of a sound horse and that of the defective one sold to him. By virtue of this rule courts now allow the purchaser to collect damages arising from the loss of an intended use or a profitable sale of an article, provided these facts were communicated to the seller at the time the contract was made. In *Josling* v. *Kingsford*[69] the purchaser was permitted to recover damages upon a contract for the sale of oxalic acid. Upon investigation the court found that the liquid delivered in this instance did not come within the description of that chemical. In another English case,[70] a commodity, which was sold under the name of "scarlet cuttings" and intended primarily for the trade with China, was found to be scarlet cloth of another kind. Lord Ellenborough

[66]Mr. Justice Story has explained this rule as it applies to personal property: "the purchaser buys at his own risk,—*caveat emptor,*—unless the seller either give an express warranty; or, unless the law imply a warranty from the circumstances of the case, or the nature of the thing sold; or, unless the seller be guilty of a fraudulent representation or concealment in respect to a material inducement to the sale." Story, Sales, (4th ed.) 401; See Barnard *vs.* Kellogg (1870) 77 U. S. 383; Gaylord Mfg. Co. *vs.* Allen (1873) 53 N. Y. 515; Porter *vs.* Bright (1876) 82 Pa. 441; Mixer *vs.* Coburn (1846) 52 Mass. 559; Dean *vs.* Morey (1871) 33 Iowa 120; Roseman *vs.* Canovan (1872) 43 Cal. 110; Armstrong *vs.* Bufford (1874) 51 Ala. 410.

[67]Hadley *vs.* Baxendale (1854) 9 Exch. 341.

[68](1800) 3 Esp. 82.

[69](1863) 13 C. B. (N. S.) 447; 7 L. T. R. (N. S.) 790.

[70]Bridge *vs.* Wain (1816) 1 Stark 504.

charged the jury to the effect that if the cloth was sold under the name of "scarlet cuttings" in the invoice, the plaintiff was entitled to recover the profits which he would have made in the China market had the cloth been what it was supposed to be. If this commodity was a staple with a definite price, it is plain that profits here were easily ascertained.[71]

The second class of cases refers to a breach of contract on the part of the seller who has agreed to deliver a commodity at a certain time and place. If the purchaser needed this commodity in a particular enterprise, the productive process may have been seriously interrupted, and perceptible risk-losses may have been sustained. Indeed, unless he could have secured immediately another commodity of the same kind and quantity, his utility profits would at least have been placed in jeopardy. True, the courts do not think in terms of utility profits, but they have, nevertheless, realized that if he is deprived of a concrete good he suffers a distinct loss of its *use value* to himself. They have, therefore, constructed a rule of damages which will ultimately restore to him the commodity for which he had bargained. This is done in two ways. If his loss cannot be estimated in terms of money, courts will probably compel the seller to perform the established contract. But in the usual case, the purchaser may collect the difference between the stipulated price and the market value of the commodity at the time it should have been delivered. By using proper foresight, then, at the termination of the contract he may purchase the desired good in the open market and thus escape the threatened interruption to his business and the corresponding risk loss. By this method the courts here relieved the plaintiff of all risk loss in securing the concrete good and his proper utility profits.[72]

V. In passing to the subject of external risk profits we have, as

[71]In the suit of Allan *vs.* Lake (1852) 18 Q. B. 560, the defendant sold a crop of growing turnips under the description of Skirving's Sweedes, but when they had matured, it was found that the seed used in planting them was of another sort. The seller of the seed was then sued for damages. It was held that the statement that the seeds were of a definite variety was a particular description of a known article of trade, which amounted to a warranty; and the plaintiff was, therefore, allowed to collect damages.

[72]Many cases could be cited which uphold this principle of law, but they are reserved to illustrate, in another place, the presence of a scarcity surplus that may accrue to a mere speculator, who would simply have resold the commodity in the open market. It is obvious that by this ruling, the damages for breach of contract, secured by a trader or speculator, amount in reality to a pure value increment.

will be seen, crossed the line which separates such returns from internal risk gains. As we have previously observed the contrast is plain. Internal risk profits arise solely from improvements in the concrete productive process, that is, by reducing the losses on the entrepreneur's expenditures and on the final product. External risk profits, on the other hand, relate solely to exchange values as distinct from values in use; and are made permanent by any economic or legal means which will prevent fluctuations in exchange value. When the profits of an enterprise have become so fixed and certain that a court is willing to make them an ultimate measure of damages, risks have become so scientifically reduced that the entrepreneur is probably receiving the full money value for his utility profits. It is, therefore, clear that when external risk profits become firmly established, the other forms of efficiency returns also become reasonably certain. In other words, in the four groups of cases which are to be examined here, we have entered into the problem of exchange value; and considerable difficulty is found in separating this form of risk profit from pure scarcity surpluses. Obviously, where active competition does not exist, prices will tend to rise above the point necessary to prevent external risk losses; and the presence of scarcity surpluses will tend to conceal efficiency profits.

(a) In the first group of cases the purchaser has agreed to take a certain commodity from the entrepreneur at a fixed price, but fails subsequently to keep his contract. Fear of certain loss often impels a person to break his agreement, and it is patent that he thus injures the producer, who must take the risk of disposing of his product to another person. As the commodity is assumed to be still physically perfect, any loss would necessarily arise from a decrease in exchange value. A familiar instance may be selected in which the entrepreneur has agreed to supply building materials to a second person. By breaking his contract the purchaser in this case is liable in damages for the loss which has fallen upon the entrepreneur; for the latter is entitled to the full value of his product. In particular instances the entrepreneur may not have gone to the full expense of performing his part of the contract; but he is, nevertheless, entitled to all prospective profits which he would have made by fulfilling the agreement. It will be noted that, if he has been put to but slight expense, his profits consist almost entirely of a pure value surplus. Cases which adequately

illustrate this point have, therefore, been reserved for another place to explain one form of the scarcity profit.

(b) The second class of cases also involve a contractual surplus. The usual contract is made between the buyer and seller of a commodity, but the latter is unable to keep his agreement because of an injury by some third person to the productive process or to the final product. As his profits are fixed and certain by the terms of the contract, the courts are inclined, in more recent decisions, to allow as damages the profits which he would have made if he had not suffered the injury. We may note here that in a decision of 1858, the court refused to permit the value of certain orders for the picture of Henry Clay to be taken as the measure of damages.[73] But it is hardly necessary to state that this decision is not in harmony with the more advanced legal opinions. In fact, a manufacturer of patented machines in North Carolina was allowed to recover the prospective profits on all orders which he had actually received for these instruments. But he was given no additional amount for future profits; and the conservative character of the decision is seen in the fact that the court refused to consider the returns of the previous year as a measure of compensation.[74] On this same point, the courts of New York have also seen fit to include in the measure of injury the profits which a plaintiff had lost on orders actually received.[75] Obviously, the courts cannot ignore the fact that this form of contractual profit, barring the injury complained of, is wholly the result of past sales and fully as definite as the returns of credit accounts of any past year. Moreover, if the contracts are made under freely competitive conditions, scarcity increments will be at a minimum.

(c) A third division of this group of cases includes only those contracts which are made between the buyer and seller of a business. It is customary for the seller of an enterprise to agree that he will not, within a certain period, enter into competition with the purchaser. The object of this agreement is to give the purchaser, as far as possible, the goodwill of the business. But in the cases under consideration, the seller had broken his contract; and the large number of opinions rendered here covers a great variety of circumstances. For example, the seller is often subject to a

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[73] Bennett *vs.* Drew (1858) 3 Bosw. 356.

[74] Jones *vs.* Call (1887) 96 N. C. 337; 2 S. E. 647; See Oldham *vs.* Kerchner (1878) 79 N. C. 106; Lewis *vs.* Rountree (1878) 79 N. C. 122.

[75] Capel *vs.* Lyons (1898) 3 Misc. 73; 22 N. Y. Supp. 378.

definite penalty if he breaks his contract, and this sum is usually more than sufficient to cover losses from his illegal competition.[77] At the same time, if these contracts do not seriously lessen competition, scarcity profits are, of course, largely eliminated. But under this form of contract trade is often restrained, and both efficiency and scarcity profits are frequently accumulated. True, it is to be observed here that the courts often decline to enforce contracts in restraint of trade, provided competition is thoroughly eliminated, or that the restraint is plainly prejudicial to public interests. Profits cannot be recovered, then, if it is discovered that such contracts are in illegal restraint of trade.

(d) In the fourth class of cases external causes exert a marked influence upon the value of a commodity. Many methods of maintaining exchange values exist besides that of a predetermined contractual price. Not the least effective means appears in the form of a tacit understanding between dealers to regulate the sale of commodities. Another method is seen in the conscious effort of trade unions to prevent the decrease of wages. When either of these persistent combinations push prices above the marginal cost of production, a scarcity and, perhaps, a monopoly profit may be realized. On the other hand, of a somewhat different nature is the form of contract by which competitors are, without the purchase of goodwill as in previous cases, prevented from injuring one's business. Thus in the sale or lease of land, it is permissible to exclude persons from entering into competition with a prescribed business. For example, one may be forbidden to sell sand from a tract of land, or coal from a certain dock. Or again a competitor may be restrained from erecting a mill[78] or a hotel on a particular piece of land.[79] This form of contract has often been violated, and one federal court has decided that the plaintiff might recover compensation for the profits which his business actually fell short of what he might have made, if no competition had resulted from the acts of the defendant.[80]

Of an entirely different character is the group of cases in which demand for a commodity is increased by improvements

[77] Oregon Steam Nav. Co. *vs.* Windsor (1873) 87 U. S. 65; American Strawboard Co. *vs.* Haldeman Paper Co. (1897) 83 Fed. 619; Hubbard *vs.* Miller (1873) 27 Mich. 15; Roeber *vs.* Diamond Match Co., (1887) 106 N. Y. 473, 13 N. E. 419.

[78] Norman *vs.* Wells (1837) 17 Wend. 136.

[79] Stines *vs.* Dorman (1874) 25 Ohio St. 580.

[80] Hitchcock *vs.* Anthony (1897) 83 Fed. 779.

wholly outside one's business. The erection of a factory or a university in a city brings to it new enterprises and consequently an increase in trade. So one may create new opportunities for sales by stipulating in a contract that a store shall be erected on a definite site; and in a particular instance a scarcity profit of four dollars an acre was collected as damages.[81] In this connection one, who had been induced to move his business to a certain town by the false statement that a railroad was about to be constructed to it, was given damages in proportion to his profits before the removal.[82] In cases of this kind, however, the rule of damages is generally based on the estimated increase in value which would have resulted from the improvement of the factor. Thus the measure of compensation is, not the anticipated profits of a business, but the difference in value of the plaintiff's property, as it would have been with the contemplated improvements, and as it exists without them.[83] But at this point the entrepreneur's efforts to resist market losses and to increase the value of his property not infrequently result in a scarcity contractual surplus.

Finally, it is apparent that among the "gains prevented" are to be counted the losses from wrongful injury to property and from breach of contract. These are risk losses. But when a remedy exists these losses may be turned by court decisions into external risk profits and restored as damages to the entrepreneur. If the productive process here remains unimpaired, while the injury arises entirely from loss of value, the court has restored simply the external risk profits. These compensate the entrepreneur for the utility which he has created. True, a scarcity surplus may accumulate at times; this is seen particularly in connection with natural agents. The sphere of external risk profits borders, then, on the competitive line of demarcation between the earned increment and the fluctuating scarcity gains which the courts do not recognize as a proper basis of damages. With the conclusion of this description of external risk profits in the industrial world, the task set apart for this article has been finally completed.

The importance of efficiency profits in law cannot be over emphasized, and in presenting this plan of classification, two fundamental conditions are always borne in mind. First, it is assumed here that the entrepreneur's residual surplus in the particular

[81] Iowa Land Co. *vs.* Conner (1907) 136 Iowa 674, 112 N. W. 820.

[82] Arkansas etc. Co *vs.* Lincoln (1895) 56 Kan. 145, 42 Pac. 706.

[83] Ironton Land Co. *vs.* Butchart (1898) 73 Minn. 39, 75 N. W. 749; Smith *vs.* Los Angeles *etc.* Ry. (1893) 98 Cal. 210, 217, 33 Pac. 53.

cases examined has arisen under freely competitive conditions. The accumulation of speculative profits over a long period of time will then be neutralized to a large extent by corresponding losses. Moreover, even the contractual surpluses considered here have been determined by competition and under normal conditions will not greatly exceed the profits of efficiency. Second, the decisions of the courts reject in a most positive manner any effort to include indefinite or uncertain profits within the measure of damages. Such opinions naturally tend to eliminate speculative profits from the rule of compensation. Even remote profits are rejected by American courts. That there may be absolutely no exception, theoretically, to this presentation of efficiency profits, the legal rule of compensation has been traced carefully in relation to all forms of efficiency returns. This plan of profit analysis has, therefore, been applied to concrete industrial conditions in which the opinions of our courts are uniformly consistent.

Yet this group of cases embraces a large industrial field and several essential facts may be emphasized:

I. At present profits are accepted as reliable in most agricultural pursuits. Also, the returns upon fishing, dairying, cattle raising, ice-cutting, wood-cutting, peddling, real estate business, and some forms of mining are found to be sufficiently certain to serve as a basis of damages. In other words, the evolution of law is gradually including more and more within the rule of compensation the profits of manufacturing and commerce.

II. The earnings of the entrepreneur in the form of wages of management have from the earliest times been included in the compensation allowed him for personal injury. And while certain states are uniformly consistent in excluding in this instance gains on capital as a measure of damages, there is, nevertheless, a gradual breaking up of this policy in other sections and an extension of the rule to the profits of an entire business.

III. Many devices are used to overcome market risks and reduce losses. In conserving efficiency profits, the entrepreneur often restricts trade; and in maintaining the individual right of contract, the courts include unearned and scarcity profits in the measure of damages. Especially has the use of contracts in maintaining prices brought about a change in court decisions, for such values become fixed and certain. Needless to say, this evolution is most pertinent to a proper analysis of profits. It has allowed

a gradual legalizing of unearned scarcity surpluses obtained wholly by contractual restraint of trade.

IV. During certain periods abnormal profits greatly increase the amount of investments. At this time unearned surpluses instead of the returns of efficiency dominate the struggle for profit and the presence of scarcity gains may obscure the plan of analysis followed in this discussion. Indeed, the constantly increasing incomes of this nature afford a wide field for investigation, and only eternal vigilance on the part of courts and legislators will prevent the unnecessary growth of this increment.

V. Finally, as the economic sphere of the individual in law has grown constantly broader, his legal correlation of supply to consumption has become more fixed; he has been able to restrain competition, exploit demand, and not infrequently monopoly has resulted. In this fact there lies an ever growing danger, for the competitive plane, which has long controlled the determination of legal profits, is gradually losing its significance in the common law. To be sure our courts still retain the age-long competitive principle. But the evolution of individual rights has forced upon us closer economic relations and compelled us to observe certain rules of cooperation which are steadily welding the American people into a more compact industrial union. In fine, this steady socialization of legal principles has not seldom rendered ineffective the competitive plane and borne with great severity upon both producer and consumer. It is therefore essential to give heed to leading decisions which greatly influence the cooperative accumulation of both efficiency and scarcity profits; and by drawing again the competitive line of demarcation between the earned and the unearned residual surpluses of the entrepreneur, it may be possible to place a check upon persistent forms of industrial and legal evolution which constitute a serious menace to our social and economic well being.

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by express assignment of the covenant.[61] Thus it would follow that the covenant for the benefit of the business would pass by implication, not to the assignees of the reversion as such but to the transferees of the business.[62]

A study of the "tied house" cases indicates clearly enough that on principle the doctrine of the running of the benefit of restrictions is applicable to personal property generally, and that the benefit of the restriction will pass by implication with the personal property to be benefited. This view, however, is inconsistent with the later English cases which tend to limit the doctrine to real estate,[63] where there is a dominant tenement,[64]—a tendency which, as already pointed out, has had an unfortunate effect on the development of law.

It has become the fashion to speak of the decadence of equity in our Anglo-American system of jurisprudence. In matters of procedure there is undoubtedly some justification for such a reference to the equity system, since we no longer are required in most jurisdictions to seek equitable relief before a separate court or by a distinct system of procedure, and we everywhere witness the gradual taking over of equity doctrines by courts of law wherever distinctly legal procedure will admit of such a process.

But the history of the development of the law of restrictive covenants and agreements since *Tulk* v. *Moxhay* in 1848 is a typical example of the way in which doctrines developed by courts of equity continue to be a vital force in our law, by which it retains its flexibility and adaptability to new and changing conditions. It shows how these doctrines mould the more rigid and unyielding rules of law so as to make effective the intention of contracting parties and conform those rules to the economic needs and the moral standards of the community.

Consideration of the ways in which equity has extended the rights and liabilities upon contracting third persons will lead to the conclusion that, as an effective instrumentality for expanding and developing our law, equity is in no proper sense decadent, but is rather a vital force.

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[61] Kemp *v.* Baerselman [1906] 2 K. B. 604.

[62] See Lindley, M. R. in Birmingham Breweries *v* .Jameson (1898) 78 L. T. 512, 514; see also John Brothers *etc.* Co. *v.* Holmes, *supra,* footnote 57.

[63] See 18 Columbia Law Rev. 309.

[64] See London County Council *v.* Allen [1916] 2 K. B. 880.

CONTRACTUAL GROWTH OF UNEARNED PROFITS.

The modern common law of both England and the United States has plainly sanctioned an unearned surplus and declared legal various forms of monopoly gain. New rights have been created by legalizing scarcity surpluses derived wholly from the growth of demand and goodwill. Long lists of opinions have established new restraints upon trade by means of which the value of goodwill has been increased, capitalized, and made to yield great gains. Contractual rights have been used to establish social and legal relations that afford opportunity for accumulating huge unearned increments,—relations which possess essentially the same characteristics as private property in land; and, as they afford differential advantages, the scarcity surplus is not unlike rent. Individuals prize these rights because they give opportunity to secure wealth created by others, and their value to the entrepreneur is in proportion to the amount of the unearned increment thus acquired above the costs of production. These rights are obviously not the result of the productive efforts of men, but permanent opportunities created solely through the evolution of law. The contractual surplus of the exploiter depends entirely upon the trend in judicial opinion and the inability of society to redress its wrongs.

The unearned scarcity surplus exists because one of the individuals in a bargain has given more for an economic good than its cost plus all earned profits. Every such gain is obtained at the expense of the consumer. It measures in every instance the surplus utility forced from him by stress of circumstances; and under freely competitive conditions, it rises and falls entirely in harmony with the variations of demand. It is then a simple market surplus, and is therefore termed here a speculative profit. In judicial opinions the term "speculative" embraces not only this form of surplus but also the profit of efficiency, because at times either may be more or less contingent in character. However, these different returns should be carefully distinguished. The former is a pure value surplus, while the latter, though sometimes contingent, is nevertheless the reward of efficiency.

Strangely enough, of all the pure value surpluses, only speculative profit and rent were considered legal under the early common law. The market surplus was always a variable quantity; price was never permanently fixed or predetermined; and the law

compelled buyer and seller to bargain and higgle freely with each other. In fact, English courts suppressed the unearned surplus by maintaining equal market opportunities for both buyers and sellers. As late as 1800 it was a crime to speculate in the necessaries of life or to spread rumors for the purpose of enhancing prices. The essential rights of both sellers and consumers to enjoy a free and open market are presented in an illuminating opinion:

> "God forbid that this court should do any thing that should interfere with the legal freedom of trade. In support of it the law has declared, and that law has repeatedly been acted upon, that to violate the freedom of trade by intercepting commodities in their way to market, taking them from the owner by force, or, which is the same thing, obliging him to accept a less price than he demands, and carrying them away against his will, or committing the like violation upon him in the market, is a capital offence, for which men have forfeited their lives to the law; for the law so far protects the freedom of trade as to encourage men to bring their goods to market, by punishing those who by acts of violence deter others by so doing. But the same law that protects the proprietors of merchandize takes an interest also in the concerns of the public, by protecting the poor man against the avarice of the rich; and from all time it has been an offence against the public to commit practices to enhance the price of merchandize coming to market, particularly the necessaries of life, for the purpose of enriching an individual. * * *
>
> "That law, for the protection of those who are obliged to resort to market for the purpose of purchasing, we are bound to administer, as well as that which exists to protect those who resort to market for the purpose of selling."[1]

Stated concisely, it was formerly against public policy to demand a set or fixed price. Neither could prices be established by agreement. The all-important competitive principle protected alike producer and consumer. The former was not to be hindered in marketing his goods freely; and the latter was to have an opportunity to purchase commodities at a fair price. The consumer's rights in the market were at that time fully as important as those of the seller; and to maintain proper exchange values, laws were at one time enacted against engrossing, regrat-

[1] King *v.* Waddington (1800) 1 East. 143, 163 *et seq.*

ing and forestalling. A fair price to the consumer was the customary or usual value of a commodity; and this ancient rule, therefore, made the exchange price depend ultimately upon the constituent elements of its cost.

American courts seem to have largely overlooked the case of *King* v. *Waddington,* but other English decisions were relied upon for a time to support the principle of free competition. The public policy of a free and open market was given support in three decisions. In *People* v. *Fisher*[2] Chief Justice Savage said:

> "Combinations and confederacies to *enhance* or *reduce* the prices of labor, or of any articles of trade or commerce, are injurious. They may be oppressive, by compelling the public to give more for an article of necessity or of convenience than it is worth; or on the other hand, of compelling the labor of the mechanic for less than its value."

Again, he says:

> "It is true, that no great danger is to be apprehended on account of the impracticability of such universal combinations. But if universally or even generally entered into, they would be prejudicial to trade and to the public; they are wrong in each particular case. The truth is, that industry requires no such means to support it. Competition is the life of trade."[3]

Again, in *Hooker* v. *Vandewater,*[4] it was stated:

> "That the raising of the price of freights for the transportation of merchandise or passengers upon our canals is a matter of public concern, and in which the public have a deep interest, does not admit of doubt. It is a familiar maxim, that competition is the life of trade. It follows, that whatever destroys, or even relaxes, competition in trade, is injurious if not fatal to it."

In a similar case in the same state during the following year a like decision was rendered in which common law principles were carefully reviewed:

> "It is nothing less," declared the court, "than the attainment of an exemption of the standard of

[2] (N. Y. 1835) 14 Wend. 9, 18.

[3] *Ibid,* p. 19.

[4] (N. Y. 1847) 4 Denio 349, 353.

> freights, and the facilities and accommodations to be rendered to the public from the wholesome influence of rivalry and competition."[5]

Furthermore, to the objection of an attorney that the dealers in a particular city or place often had a tacit understanding from day to day as to the price of a commodity, the court replied:

> "That is true, and it is not necessary to inquire whether such a system might not be carried so far, and be accompanied with such circumstances and regulations as to render it unlawful."[6]

The articles of association in the case were therefore held to be illegal. Mr. Justice McKissock states in this opinion that the articles "unquestionably contravene public policy, and are manifestly injurious to the interest of the state."[7] This statement seems to contain what was at that time the accepted theory of the common law. But this principle was, however, soon to be overthrown; and an old English case furnished the necessary precedent to turn judicial opinion and to secure its rejection by American courts.

This was the remarkable case of *Mitchell* v. *Reynolds*,[8] wherein a general restraint upon trade was declared to be illegal. It was emphasized that a contract not to trade in any part of England was void, for "it can never be useful to any man to restrain another from trading in all places, * * * unless he intends a monopoly, which is a crime."[9] Contracts were therefore divided at this time into those which work a general restraint of trade and those which affect it to a less degree.

From this notable case may be traced five legal-economic principles which have vitally influenced the accumulation of the unearned increment. These fall naturally into two groups. The first three tend to restrict competition; the last two tend to preserve it.

I. Voluntary contracts and agreements accompanied with adequate consideration should be fully protected and seldom set aside.[10] This is one of the most important principles of the

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[5] Stanton *v.* Allen (1848) 5 Denio 434, 440.

[6] *Ibid*, p. 442.

[7] *Ibid*, p. 443.

[8] (1711) 1 Peere Will 181.

[9] *Ibid*, p. 193.

[10] *Ibid*, p. 191, 5thly.

common law. It guarantees the individual right of contract,—that is, freedom of economic action within a prescribed sphere. Freedom of contract, then, bears an important relation to the competitive principle; for as the right of contract changes so must the scope of the competitive principle. Zealous in maintaining this contractual privilege, the former competitive principle has been largely modified by state courts and restraint of trade is allowed to take place up to the point at which a monopoly is finally established.

II. It was asserted that contracts in partial restraint of trade may prove beneficial to the community by eliminating competition or reducing the number of enterprises.[11] This was a distinct departure from the ancient competitive principle which had long served to nullify or to check restraints upon trade and competition. It was a comment that was taken up, however, and emphasized in American law more than a century after it was made. It allows combination between producers for the express purpose of eliminating competition; and it has served as the basis of a new economic principle in legal opinions which has greatly influenced the distribution of wealth.

Freedom of trade has, in part, given way to freedom of contract. The competitive principle has been greatly restricted by American courts; the more modern interpretation of "a fair price," due to the spirit of commercial speculation, tends to allow the entrepreneur all that the trade will bear. This important departure from ancient principles is due largely to the evolution of contractual rights in relation to the exploitation of demand. To be sure, courts of law rigorously protect the principle of public policy by which the welfare of the state is preserved. The welfare of the nation surmounts, of course, the rights of any individual. Yet constant evolution of the contractual right has encroached upon the ancient sphere of public policy. For good or evil the former limits of public policy have been restricted in this respect and freedom to contract has been greatly enlarged. Not the least important factor in this great change in legal reasoning was the ancient case of *Mitchell* v. *Reynolds*,[12] which came almost a century prior to the decision of *King* v. *Waddington*.[13] Only twenty-

[11] *Ibid*, p. 191, 4thly.

[12] *Supra*, footnote 8.

[13] *Supra*, footnote 1.

five years after the latter case, an issue relative to the restraint of trade arose in a Massachusetts court. A certain merchant had agreed to relinquish his interests in the boating business, to give all of his freight to a particular boatman on the Connecticut river, and not to encourage any other competitor. After reviewing in part the discussion of restraint of trade in *Mitchell* v. *Reynolds,* Mr. Justice Welde concluded concerning the issue:

> "It must therefore be decided on general principles, rather than by express authority. Whether competition in trade be useful to the public or otherwise, will depend on circumstances. I am rather inclined to believe, that in this country at least, more evil than good is to be apprehended from encouraging competition among rival tradesmen engaged in commercial concerns. There is a tendency, I think, to overdo trade, and such is the enterprise and activity of our citizens that small discouragements will have no injurious effect in checking in some degree a spirit of competition. An agreement with a tradesman to give him all the promisor's custom or business, upon fair terms, and not to encourage a rival tradesman to his injury, can hardly be considered as a restraint of trade. Certainly it is not such a restraint as would be injurious to the public, for in proportion as it discourages one party it encourages another."[14]

The courts of New York soon reversed their former opinions and other states likewise took up the new economic principle that competition may be restrained when injurious to trade. In 1839 a large combination of vessel owners which had driven the principal competitor out of business and raised the rate of passenger fares on the Erie canal was declared legal. "Competition in business," said the court, "though generally beneficial to the public, may be carried to such excess as to become an evil."[15] In 1851 an association of warehousemen and mill owners formed for the purpose of depressing and controlling the price of wheat in Milwaukee was held good on the same ground. The court denied that competition is the life of trade. The maxim was condemned in no uncertain words:

> "It is in fact the shibboleth of mere gambling

[14] Palmer *v.* Stebbins (1825) 20 Mass. 188, 192 *et seq.*; also quoted in Whitney *v.* Slayton (1855) 40 Me. 224, 230 *et seq.*

[15] Chappel *v.* Brockway (N. Y. 1839) 21 Wend. 157, 164.

> speculation, and it is hardly entitled to rank as an axiom in the jurisprudence of this country."[16]

In 1855 the Supreme Court of Maine, following the opinion of the Massachusetts court,[17] referred to the ancient rule against restraint of trade as follows:

> "This, then, is not the country, or the time, when it is expedient to enforce rigorously the ancient common law rule, and restrict the exceptions to narrow limits, but rather to give the latter a liberal construction."[18]

In all the early cases the idea that limitation of competition is good for trade, seems to have been drawn directly from the provisions selected here from the opinion in *Mitchell* v. *Reynolds*.[19] In short, this famous case furnished the theoretical basis of a most important economic doctrine. And upon the American courts must fall the responsibility and the credit for perpetuating in American law a theory that needed only present economic conditions to make it of tremendous importance.[20]

III. It was asserted that the owner of a business possesses a legal right to his custom or goodwill which may be parted with under certain conditions.[21] Beginning with this brief opinion, the increasing importance of goodwill has gradually influenced the contractual restraint upon trade and the growth of the unearned surplus. Contracts of which goodwill constitutes the economic basis of trade restraint are innumerable. Furthermore, the economic and legal phases of goodwill are constantly increasing in complexity, affording an ever-growing opportunity for contractual restraint and the accumulation of unearned increments. Mr. Justice Story has broadly defined goodwill as,

> "the advantage or benefit which is acquired by an establishment beyond the mere value of the capital,

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[16] Kellogg *v.* Larkin (Wis. 1851) 3 Pin. 123, 150.

[17] Palmer *v.* Stebbins, *supra,* footnote 14.

[18] Whitney *v.* Slayton, *supra,* footnote 14, at p. 231.

[19] *Supra,* footnote 8.

[20] Leslie *v.* Lorillard (1888) 110 N. Y. 519, 534, 18 N. E. 363; National Benefit Co. *v.*Union Hospital Co. (1891) 45 Minn. 272, 47 N. W. 806; Oakdale Mfg. Co. *v.* Garst (1894) 18 R. I. 484, 487, 28 Atl. 973; U. S. *v.* Nelson (1892) 52 Fed. 646, 647; Slaughter *v.* Coal and Coke Co. (1904) 55 W. Va. 642, 649, 47 S. E. 247.

[21] Mitchell *v.* Reynolds, *supra,* footnote 8, at p. 191, 4thly.

stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices."[22]

Yet broad as this definition is, it is largely a hasty collection of ideas, without proper citations from legal opinions. It does not cover the subject of goodwill so as to give us a clear idea of its exact nature or contents. Indeed, judicial definitions of goodwill are disappointing because there is really no scientific treatment of the subject from an economic standpoint. Courts have defined goodwill almost entirely as an incident of the productive process. In fine, it is usually treated as property and as an essential element of the technical process. Certainly there has been a failure to study goodwill in its proper relation to wants and demand. Because of this fact, contracts have been allowed to restrain competition, coerce the consumer's goodwill, and to extract from the public an unearned surplus. It will therefore be necessary to point out briefly how these methods of legal restraint have increased and rendered permanent the profits of goodwill.

IV. It was declared that contracts in general restraint of trade tend to deprive one of the parties to it of his livelihood and the state of the services of a useful member.[23]

V. It was emphasized, finally, that contracts in general restraint of trade—as excluding one from trading in any part of England—tend to centralize control over industry and to create monopolies.[24]

These five principles are of great pertinency to all contracts in restraint of trade which have arisen since the time of the early Mitchell case. It will be seen at once that whether the individual be buyer or seller, the first three principles have served to increase both his contractual rights and his opportunities to limit competition. The last two principles, on the other hand, stand out as important checks on the first three. But even here, the

[22] Story on Partnership, § 99.

[23] Mitchell *v.* Reynolds, *supra,* footnote 8, at p. 190, 2ndly.

[24] *Ibid,* p. 190, 2ndly; 193, 3rdly.

rigorous enforcement of legal remedies against restraint of trade has been gradually relaxed, and these two principles have become greatly modified. Freedom of the individual to contract has seriously interfered with the ancient competitive regime; and industry has been forced to flow in artificial channels.

There are at least five distinct classes of agreements which have established trade restraints and rendered more or less permanent the profits of goodwill. Upon these contracts courts have passed important opinions. The first four relate especially to the entrepreneur's rights in goodwill, while the last concerns more particularly the advantages of efficiency in the physical process itself. Of course, courts of law have often included also these advantages of efficiency in goodwill.

In the first group, the custom, patronage, or goodwill of a single person is secured by contract as a permanent advantage of a certain enterprise. Consequently, the profits from this form of transaction, if expenses remain uniform, become fixed and definite. Where litigation has arisen under this form of agreement, the first three principles of Mitchell's case have worked in harmony. Freedom of the individual to contract was perceptibly increased, output became fixed, and competition was correspondingly restricted. In the leading case on this question, the court could see no evil in eliminating competition, but on the contrary maintained that a social good resulted. Moreover, it was stated in positive terms that,

> "It would be extravagant to suppose that any one by multiplying contracts of this kind, could obtain a monopoly of any particular trade."[25]

Obviously, the court failed to note that just such contracts may be used to create monopolies and that they are fundamentally wrong from an economic standpoint. There would be less objection to a contract which provides for the purchase or sale of a definite quantity of goods, leaving all persons free to engage in other transactions. But this form of agreement is an exclusive contract. It usually includes *all* of a vendor's product or *all* of a buyer's patronage, and, therefore, lays the basis of an exclusive privilege. Goodwill becomes permanently attached to a definite enterprise. In fine, this privilege becomes a differential advantage and not infrequently the means of securing a coerced unearned gain either from producers or consumers.

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[25] Palmer *v.* Stebbins, *supra,* footnote 14, at p. 193.

To be explicit, this mode of contracting has been used as a means to control markets, to exploit the public, and to secure monopoly advantages. Thus it has been used by a common carrier to secure permanently large quantities of freight traffic in return for lower rates.[26] A company engaged in the manufacture of wall paper was able to secure a contract with two manufacturing machine companies by which the latter agreed to sell their machines exclusively to it.[27] Again a contract offered by an electric lamp combination, providing that tungsten lamps were to be sold only to jobbers who agreed to purchase *all* of their carbon-filament lamps from the company, was assumed to be valid although such dealers were practically compelled to purchase three types of lamps under this agreement.[28] More pointedly, in a suit against a tobacco manufacturer who had discriminated between customers by selling certain products at a lower price to those who would not handle competing goods, the court was positive that the tobacco company had a right to fix the prices and the terms upon which it would contract to sell them.

> "The exercise of these undoubted rights," it was declared, "is essential to the very existence of free competition."[29]

In referring to the defendants, the court said:

> "They had the right to select their customers, to sell and to refuse to sell to whomsoever they chose, and to fix different prices for sales of the same commodities to different persons. * * * There was nothing in this selection, or in the means employed to effect it, that was either illegal or immoral."[30]

In fact the doctrine that it is legal and right to favor exclusive dealers has been approved in many decisions, and only recently have courts recognized the economic importance of the exclusive contract.[31]

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[26] Wiggins Ferry Co. *v.* Chicago & Alton R. R. (1881) 73 Mo. 389, 407.

[27] Continental Wall Paper Co. *v.* Lewis Voight & Sons Co. (1906) 148 Fed. 939, 952.

[28] United States *v.* General Electric Co., by consent decree was entered Oct. 12th, 1911, in the Federal District Court for the Northern District of Ohio.

[29] Whitwell *v.* Continental Tobacco Co. (1903) 125 Fed. 454, 461.

[30] *Ibid,* p. 461.

[31] For example, in the case of United States *v.* Eastman Kodak Co. (1915) 226 Fed. 62, 65, the court said, "Monopolies are created in various ways, and may constitute partial restraints of trade which of themselves

Moreover, where the supply of a good is limited, the exclusive contract has often become in the hands of one person the basis of a monopoly, and has in some instances been declared illegal. In certain counties of California, the price of lumber for the year 1881 was controlled by securing contracts from several mills for specified amounts of output which, it was agreed, should consti-

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are not unreasonable, and contracts or combinations creating them are not necessarily invalid. The statute prohibits only such monopolies as are unjust and unreasonable restraints of trade." Again, this federal court said in relation to the legality of exclusive contracts: "Defendants argue generally that manufacturers have the legal right to encourage dealers by extra profits or by other fair inducements to handle their goods exclusively, that such an arrangement is to the interests of both, and that the Eastman Kodak Company was the first to induce stationers, druggists, and others to handle photographic goods as a side line. All this and more, it may be conceded, separated from other acts, might furnish no ground for holding that there was an illegal monopoly; but the arbitrary enforcement of the restrictive conditions by the establishment of a system of espionage, and the keeping of records of violations of such conditions, with a view of penalizing such dealers, are evidences of an intention to promote a monopoly." *Ibid,* p. 77 *et seq.*

A strong comment upon this form of the exclusive contract may be found in the Cream of Wheat case. In the opinion of Judge Hough, "Numerous individuals and corporations have been enjoined from restraining the trade of other people, * * *. But never before has it been urged that, if J. S. made enough of anything to supply both Doe and Roe, and sold it all to Doe, refusing even to bargain with Roe, for any reason or no reason, such conduct gave Roe a cause of action." Great Atlantic & Pacific Tea Co. *v.* Cream of Wheat Co. (1915) 224 Fed. 566, 574. In the Circuit Court of Appeals, to which the case was carried, Judge Lacombe made a similar statement. "We had supposed," said the judge, "that it was elementary law that a trader could buy from whom he pleased and sell to whom he pleased, and that his selection of seller and buyer was wholly his own concern." Great Atlantic & Pacific Tea Co. *v.* Cream of Wheat Co. (1915) 227 Fed. 46, 48.

Other examples will show the substantial place of this form of contract in law. In Wilder Mfg. Co. *v.* Corn Products Co. (1915) 236 U. S. 165, 173, 35 Sup. Ct. 398, the Supreme Court of the United States sustained the validity of an exclusive contract between a glucose manufacturer and a dealer who was to receive a percentage of the profits upon condition that he dealt exclusively with the refining company. The court said: "But we can see no ground whatever for holding that the contract of sale was illegal because of these conditions." On the other hand, an exclusive contract of this nature was declared illegal in Texas. By this agreement a Mr. Wood obtained six tons of ice a day at $3.00 a ton "or what his trade may demand" on condition that he "agrees to make all his purchases from the first party during the term of this contract." Wood *v.* Texas Ice & Cold Storage Co. (Tex. 1914) 171 S. W. 497. In Butterick Publishing Company v. Fisher (1909) 203 Mass. 122, 89 N. E. 189, an exclusive contract concerning the sale of patterns was condemned by a Massachusetts court, but in a suit brought by this same company in Wisconsin, the contract was sustained. Butterick Publishing Co. *v.* Rose (1910) 141 Wis. 533, 124 N. W. 647. In like manner the contract of a trading-stamp company in Massachusetts entered into with dealers on condition that they would not use trading stamps sold by any other company, was declared illegal, Merchants Legal Stamp Co. *v.* Murphy (1915) 220 Mass. 281, 107 N. E. 968, while a similar contract in Texas was held to be valid. Forrest Photographic Company *v.* Hutchinson Grocery Company (Tex. 1908) 108 S. W. 768.

tute their total sales for that year.[32] At another time in the same state, one man obtained agreements from several merchants to furnish him with a definite number of grain bags, as he should call for them, at a fixed price. This person did not purchase the bags, it will be observed, but because of the nature of the contract, he was able to prevent the owners from disposing of them, and thus he controlled the selling price.[33] In New York the Elmira coal market was dominated through contracts similar to the previous one, which became the means of regulating the shipment into that territory.[34] Upon the preceding facts, the agreements in these three instances were declared void because they were used primarily to enhance prices in a particular region. Nevertheless, for the time being, such contracts vested both parties to them with the unearned surplus profits of goodwill, the amounts of which depended on the economic pressure of competition between consumers. And it should be borne in mind that these agreements may serve to restrict trade effectively until some dissatisfied person seeks their abrogation by means of a legal remedy.

In the second class of contracts bearing on this subject, the social surplus and goodwill of a certain business are preserved and enhanced by eliminating both active and potential competitors. In authoritative opinions on this form of restraint, the first three principles of Mitchell's case again occupy a prominent place. Freedom of contract is further enlarged; and competition is still more definitely restricted. Thus where one individual bound himself by deed for the consideration of one dollar not to run a stage for the conveyance of passengers between Providence and Boston, the contract was held valid. "The publick," it was said, "appear to have no interest in this question. If the plaintiff did not run his stage, the defendant might run a stage, * * * And it is indifferent to the publick, which of these runs a stage."[35] This one competitor was thus effectually disposed of. A similar issue occurred in *Chappel* v. *Brockway*.[36] The owner of a packet line on the Erie canal had been forced out of business through the combination of fifty competitors and

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[32] Mill & Lumber Co. *v.* Hayes (1888) 76 Cal. 387, 18 Pac. 391.

[33] Pacific Factor Co. *v.* Adler (1891) 90 Cal. 110, 27 Pac. 36.

[34] Arnot *v.* Pittston and Elmira Coal Co. (1877) 68 N. Y. 558.

[35] Pierce *v.* Fuller (1811) 8 Mass. 223, 227.

[36] (N. Y. 1839) 21 Wend. 157.

compelled to sign the usual contract by which he relinquished the right to compete as a common carrier on that canal. The judges were well aware of the fact that the first company had apparently eliminated this single competitor for the purpose of raising its passenger rates. Upon this exact point the court said:

> "Now, this is nothing more than the usual motive for entering into such contracts, and we might as well declare them all void at once, as to give way to this objection. It does not necessarily follow that the public was injured, because the price for carrying was raised."[37]

Again, in the case of the Old Dominion Company of the same state, this view was reaffirmed, but it was made clear that when such agreements in restraint of competition "threaten the public good in a distinctly appreciable manner, they should not be sustained." That is to say, the suppression of competition in itself and the practical control of an economic field is not to be questioned until the public good is threatened.[40] In these decisions it is clear that certain commercial rivals are not only driven from business but are also forced into contracts which bar them forever from again entering that particular field. In other words, the evolution in legal construction here works steadily against the unsuccessful rival and serves to preserve the increased profits and patronage of the victorious competitor. The result of these contracts is a constantly decreasing number of competitors, and as such rivals are eliminated, the goodwill of a community may be exploited until public policy demands a remedy. This form of contract, therefore, becomes in many instances an instrument to preserve effectively the business of the more successful entrepreneur against unfortunate competitors.

The entrepreneur may increase these contractual restraints until his legal rights amount to a monopoly of the productive processes. Such contracts are then declared illegal. In that case, vanquished competitors are freed from their agreements and may again enter the competitive field. But the exact point at which outlawry begins is not always plain. Only a court of law can determine when this fateful moment has arrived; and in the meantime the public may be mulcted in proportion to their pressing needs. It is therefore plain that the evolution of this phase of the right to contract, especially pertinent in its relation

[37] *Ibid.*, p. 164.

[40] Leslie *v.* Lorillard (1888) 110 N. Y. 519, 533, 18 N. E 363.

to the operation of the legal competitive principle and the rise of the unearned increment, calls for a remedy which does not depend upon so uncertain and distant a verdict as that of any legal tribunal.

A third form of contract sanctioned by the courts is made the basis of a combination between entrepreneurs who seek to suppress competition between themselves and to regulate the price of the commodity which they produce. The idea that competition is the life of trade has not only often been ridiculed, but, as a matter of fact, the first three principles of Mitchell's case have found expression in the form of an efficiency monopoly which certain courts have already recognized as legal. It may be defined as a co-operative combination which suppresses cutthroat competition, but at the same time does not establish high prices or reap excessive profits. It has been held in England, for example, that an agreement between traders to keep up prices, if subject to reasonable limitations as to time and space, is enforceable by injunction.[41] It has also been decided that an action could be maintained on a contract against wholesale traders who bound themselves not to sell below a specified price and to procure a similar agreement from certain retailers. The court was of the opinion that the question at issue was merely whether or not manufacturers might affix what terms they pleased to a contract of sale of their own commodities.[42] A still more advanced position was taken in *Hilton* v. *Eckersley,*[43] where an agreement had been entered into, by which all the master manufacturers in a large district in England were compelled to carry on their trades for a certain period under the direction of the majority, even to closing their factories though such action would be against their own individual interests. In declaring this contract not illegal, English courts have probably taken a position upon the vexed question of restraint of trade fully abreast of any of the leading cases on this subject in the United States.

A notable example of the efficiency monopoly in the United States is set forth in the case of *United States* v. *Wanslow*[44] in which the United Shoe Machinery Company also maintained prices by means of exclusive or tying contracts. Mr. Justice

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41 Cade *v.* Daly [1910] 1 Ir. 306.

42 Elliman *v.* Carrington [1901] 2 Ch. 275; Garst *v.* Charles (1905) 187 Mass. 144, 72 N. E. 839.

43 (1855) 6 El. & Bl. 47.

44 (1913) 227 U. S. 202, 33 Sup. Ct. 253.

Holmes explained that this company, formed in 1899, had ceased to sell shoe machinery to shoe manufacturers.

> "Instead, they only let machines, and on the condition that unless the shoe manufacturers use only machines of the kinds mentioned furnished by the defendants, or if they use any such machines furnished by other machinery makers, then all machines let by the defendants shall be taken away. This condition they constantly have enforced."[45]

As to the exact nature of the combination, he said:

> "On the face of it the combination was simply an effort after greater efficiency. The business of the several groups that combined, as it existed before the combination, is assumed to have been legal. The machines are patented, making them is a monopoly in any case, the exclusion of competitors from the use of them is of the very essence of the right conferred by the patents, *Paper Bag Patent Case* 210 U. S. 405, 429, and it may be assumed that the success of the several groups was due to their patents having been the best."[46]

An efficiency monopoly formed by agreement must depend in a large measure for its legality upon the fact that potential competition still exists. By way of illustration, we may select from the state of Wisconsin a case in which twelve warehousemen bound themselves to give to the proprietors of six flour mills "full, absolute and uninterrupted control of the Milwaukee wheat market" so far as they were able to do so. It was pointed out by the court that the parties to the contract could not possibly have intended to form a monopoly; for "all the rest of Wisconsin was an open and unrestricted market for the sale of wheat."[47] Following this tendency in law, it was decided by the Supreme Court of Texas in 1893 that an agreement between two or more insurance companies to insure their rates was in a general sense a combination in restraint of trade, but that the words "restrictions in trade" to be found in the state statutes did not apply to the case.[48] Again, three of four competing companies in New England by combining their interests were able to double the value of their stock; but it was decided[49] that a monopoly was

[45] *Ibid.*, p. 216.
[46] *Ibid.*, p. 217.
[47] Kellogg *v* .Larkin (Wis. 1851) 3 Pin. 123, 145.
[48] Insurance Co. *v.* State (1893) 86 Tex. 250, 24 S. W. 397.
[49] Oakdale Mfg. Co. *v.* Garst (1894) 18 R. I. 484, 28 Atl. 973.

not formed because the field of competition was open to others. The court found a strong precedent for its decision in *Skrainka* v. *Scharringhausen.*[50] In the latter case the representatives of twenty-four stone quarries of St. Louis formed an agreement in 1878 to fix a uniform price for their output and to secure a fair, proportionate sale of the product of each enterprise. This contract was held good "because, if competition reaches such a point that goods cannot be sold at living prices, many manufacturers must be driven out of business."[51]

Clear it is, however, that a contrary tendency has appeared in American law. Under a similar agreement in New York, the manufacturers of stone in 1900 found a court of that state opposed to the doctrine of potential competition. The facts went to show that the operators' profits here were practically nominal and that they had combined for exactly the same purpose as the manufacturers of stone in St. Louis. The court, however, was fully aware of the dangers of a monopoly and, therefore, considered the contract inimical to the welfare of both the producer and the consumer.[52] This New York decision represents the more recent interpretation of the common law principle against combinations in restraint of trade; for it is enough in several states to condemn an agreement as illegal if it is of such character that there is a likelihood of its being used to enhance prices.[53] This seems to be the most hopeful recent evolution in this common law principle. But the latter cannot, however, be depended upon as an effective remedy against the accumulation of monopoly gains; for it may not be to the interest of any member of the combination to repudiate his contract and withdraw from the association. Theoretically the monopoly under this new interpretation might dissolve automatically by the withdrawal of discontented parties, but it is plain that the public could not depend upon this as a natural course of things. The legal principle is, therefore, still impotent, and it is plain that even with the most recent common law interpretation, monopolies of a very dangerous character

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[50] (1880) 8 Mo. App. 522.

[51] *Ibid.*, p. 525.

[52] Cummings *v.* Union Blue Stone Co. (1900) 164 N. Y. 401, 58 N. E. 525.

[53] Salt Co. *v.* Guthrie (1880) 35 Ohio St. 666; State *v.* Standard Oil Co. (1892) 49 Ohio St. 137, 30 N. E. 297; State *v.* Eastern Coal Co. (1908) 29 R. I. 254, 70 Atl. 1; People *v.* North River Sugar Refining Co. (1889) 3 N. Y. Supp. 401; U. S. *v.* Am. Tobacco Co. (C. C. 1908) 164 Fed. 700; Mowing Co. *v.* Hardware Co. (1906) 75 S. C. 378, 55 S. E. 973.

may be discovered in either England or the United States against which there is as yet no direct remedy.[54]

The fourth form of contract appears when the entrepreneur, in disposing of his business, virtually restrains himself from again entering that particular occupation. As his custom or patronage may be of large value, it is patent that the universal restraint which he is able to place upon himself, renders more valuable the goodwill so alienated. The recognized rule which governs this restriction provides that if the restraint is not greater than sufficient to protect the interests of the purchaser, it is not unreasonable. This rule of reason was well enunciated in the English case of *Horner* v. *Graves,*[55] and seems, moreover, to have been received with general approval. But unfortunately there is a general division among the courts of our various states relative to its construction and application.

In the first place, in the greater number of states, the rule of public policy is taken as limiting the right of a person to alienate the goodwill of his own business; and, at the same time, the last two principles of Mitchell's case have served to check restraint upon trade. In harmony with the fourth principle, the individual may not bar himself from again entering into the same business within the state. A broader interpretation of the term "reasonable" would, it is said, deprive the seller of his livelihood and the state of the services of a useful member. "It is against the policy of the state," declared the Supreme Court of Illinois, "that a citizen shall not have the privilege of pursuing his lawful occupation at some place within its borders, but must leave the state in order to support himself and family."[56] The orthodox principle was also adopted in Ohio. A manufacturer had restrained himself by covenant from making a particular kind of candle any-

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[54] Cousins *v.* Smith (1807) 13 Ves. Jr. 542; Ladd *v.* The S. C. P. & M. Co. (1880) 53 Tex. 172; Seelingson v. Taylor Compress Co. (1882) 56 Tex. 219.

[55] (1831) 7 Bing. *735. Chief Justice Tindal said, "we do not see how a better test can be applied to the question whether reasonable or not, than by considering whether the restraint is such only as to afford a fair protection to the interest of the party in favour of whom it is given, and not so large as to interfere with the interest of the public. Whatever restraint is larger than the necessary protection of the party, can be of no benefit to either, it can only be oppressive; and if oppressive, it is, in the eye of the law, unreasonable. Whatever is injurious to the interest of the public is void, on the ground of public policy," at p. 743.

[56] Union Strawboard Co. v. Bonfield (1901) 193 Ill. 420, 61 N. E. 1038; see Linn *v.* Sigsbee (1873) 67 Ill. 75; Hursen *v.* Gavin (1896) 162 Ill. 377, 44 N. E. 735; Lanzit *v.* Sefton Mfg. Co. (1900) 184 Ill. 326, 56 N. E. 393.

where in the United States. The contract prohibited the individual, of course, from engaging in that pursuit with which he was most familiar. It was said "the general effect must be, more or less to encourage idleness, and affect the price of such things as had been produced by his labor."[57] The economic argument has, however, been given more prominence in Kentucky. Such contracts are condemned on the ground that they destroy competition, injure industry, create exclusive privileges, and build up monopoly.[58] The context of these decisions make it plain that the interpretations given to these contracts were drawn largely from the early English common law doctrine, and that they coincide in the main with certain similar opinions rendered by the English courts.[59]

In the second place, the great cleavage at this point in judicial interpretation is seen when we turn to the later cases in England, New York, Rhode Island, and Massachusetts. The area and time of restraint in the sale of a business has not been confined within state boundaries; and obviously the profits of goodwill have by this means been greatly increased.

In the early history of the orthodox doctrine, English jurists had declared that it was impossible to take away a man's trade by contract for all time. Nevertheless, after a long list of similar cases, the limits of restraint affecting goodwill were relaxed. In *Rousillon* v. *Rousillon*,[60] a contract which precluded the defendant from engaging in the sale of champagne without limit as to territory was declared not unreasonable. In *Jones* v. *Lees*[61] the objection was entered that the restraint in the contract extended to all England, but Judge Bramnell replied that so did the privilege. This important departure was affirmed in the case of *Whittaker* v. *Howe*,[62] which, in fact, declared that an agreement made

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[57] Lange *v.* Werk (1853) 2 Ohio St. 519; Lufkin Rule Co. *v.* Fringeli (1898) 57 Ohio St. 596, 47 N. E. 1030; Thomas *v.* Adm'r of Miles (1854) 3 Ohio St. 274; Morgan *v.* Perhamus (1881) 36 Ohio St. 517.

[58] Sutton *v.* Head (1887) 86 Ky. 156, 5 S. W. 410; see Pike *v.* Thomas (1817) 7 Ky. 486; Grundy *v.* Edwards (1832) 30 Ky. 368; Turner *v.* Johnson (1838) 37 Ky. 435; Merchants' Ice Co. *v.* Rohoman (1910) 138 Ky. 530, 128 S. W. 599; Clemons *v.* Meadows (1906) 123 Ky. 178, 94 S. W. 13; Western District Warehouse Co. *v.* Hobson (1895) 96 Ky. 550, 29 S. W. 308.

[59] See Wiley *v.* Baumgardner (1884) 97 Ind. 66; Johnson *v.* Gwinn (1884) 100 Ind. 466; Peltz *v.* Eichele (1876) 62 Mo. 171; Gill *v.* Ferris (1884) 82 Mo. 156.

[60] (1880) 14 Ch. D. 351.

[61] (1856) 1 H. & N. 189.

[62] (1841) 3 Beav. 383.

by a solicitor not to practice law in any part of Great Britain, was not illegal; and in a comparaitvely recent case, which has had a marked influence upon American decisions, the common law doctrine seems to have been completely overthrown.[63] Thus has the rule of reason made possible final or universal restraint upon any trade within the kingdom.

A similar evolution has occurred in the United States. The rule governing a reasonable restraint in New York has followed the tendency taken in English decisions; and, the restriction, which is made co-extensive with the privilege, has often exceeded the boundary of this state. The fourth principle in the Mitchell case has been completely repudiated; for, "when the restraint is general," there is no objection if it "is co-extensive only with the interest to be protected, and with the benefit meant to be conferred."[64] Finally, succeeding cases in this state have perpetuated this theory by making legal restraint of trade universal throughout the United States.[65]

The doctrine of reasonable restraint has also taken the more radical trend in the states of Massachusetts and Rhode Island. After adhering to the strict interpretation of this common law principle for over a century,[66] the courts of Massachusetts have finally accepted the interpretations presented by the decisions on this subject in New York and England. This important recantation is couched in words for which adequate authority may be found in an English case:

> "Now the House of Lords in England," explained the court, "has held by a unanimous decision in a recent case that such a limitation which covered the whole world was not unreasonable."[67]

In even more positive terms, Rhode Island has abrogated the ancient common law rule. Its Supreme Court has ridiculed the

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[63] Nordenfelt *v.* Maxim Nordenfelt *etc.* Co. [1894] A. C. 535.

[64] Diamond Match Co. *v.* Roeber (1887) 106 N. Y. 473, 482, 13 N. E. 419.

[65] Watertown Thermometer Co. *v.* Pool (1889) 51 Hun 157, 4 N. Y. Supp. 861; United States Cordage Co. *v.* William Walls' Sons R. Co. (1895) 90 Hun 429, 35 N. Y. Supp. 978; Hodge *v.* Sloan (1887) 107 N. Y. 244, 17 N. E. 335; Tode *v.* Gross (1891) 127 N. Y. 480, 28 N. E. 469; Underwood *v.* Smith (1892) 19 N. Y. Supp. 380; Ruton *v.* Everitt (1898) 35 App. Div. 412, 54 N. Y. Supp. 896.

[66] Alger *v.* Thatcher (1837) 36 Mass. 51; Taylor *v.* Blanchard (1866) 13 Allen 375; Bishop *v.* Palmer (1888) 146 Mass. 469, 16 N. E. 299; Handforth *v.* Jackson (1889) 150 Mass. 149, 22 N. E. 634.

[67] Anchor Electric Co. *v.* Hawkes (1898) 171 Mass. 101, 50 N. E. 509.

idea that a man drives himself to idleness or to expatriation, and thus injures the public, by agreeing not to follow some one calling within the limits of a particular state.[68] In fact, universal restriction of trade within the United States has been declared not unreasonable by this tribunal; and the evidence in certain cases has made obvious the great increase of speculative values in combinations under this form of contract.[69]

Certain it is, that the issue between the strict and the broad interpretation of "reasonable restraint," as it appears in these two groups of cases, still hangs in the balance. Yet it would seem that the Supreme Court of the United States has overruled in part the narrow interpretation adopted in the state decisions of California.[70]

> "It is clear," the Supreme Court has said, "that a stipulation that another shall not pursue his trade or employment at such a distance from the business of the person to be protected, as that it could not possibly affect or injure him, would be unreasonable and absurd. On the other hand, the stipulation is unobjectionable and binding which imposes the restraint to only such an extent of territory as may be necessary for the protection of the party making the stipulation, provided it does not violate the two indispensable conditions, that the other party be prevented from pursuing his calling, and that the country be not deprived of the benefit of his exertions."[71]

This is an important decision, but what the ultimate construction will be is difficult to predict. But certainly this single decision does not afford a solution of the matter; and two economic facts here are most pertinent to the issue between these two groups of state opinions: (a) The greater number of decisions on this particular point rest on the premise, that by means of such contracts one party was necessarily deprived of his occupation. Doubtless it will be seen at once that if restraint is allowed to extend beyond state boundaries, it will not be confined within the limits of any of the other states. (b) Evidence in the cases studied here indicates that purchasers of goodwill and similar op-

[68] Herreshoff *v.* Boutineau (1890) 17 R. I. 6, 7, 19 Atl. 712.

[69] Oakdale Manufacturing Co. *v.* Garst, *supra*, footnote 49; Trenton Potteries Co. *v.* Oliphant (1899) 58 N. J. Eq. 507, 43 Atl. 723.

[70] More *v.* Bonnet (1870) 40 Cal. 254; Wright *v.* Ryder (1868) 36 Cal. 357.

[71] Oregon Steam Navigation Company *v.* Winsor (1873) 87 U. S. 64.

portunities greatly increased their profits and the value of their property by the elimination of competitors. Consequently, if universal restraint of trade is allowed in every state, the natural result will be a further tendency to form combinations and monopolies; for by purchasing the principal enterprises producing any one product, a few persons may be able by such contracts to exclude from further competition the very men who are best fitted by experience and ability to establish effective competition against concentrated industry.

Finally, there is a fifth class of contracts which relate solely to the sale of secret processes and peculiar trade advantages. To prevent the adoption and use of trade advantages by employees and the public, these are protected either by expressed or implied contracts. The latter case occurs where a confidential relation exists between persons engaged in a business venture. The law assumes an implied agreement to the effect that they will not divulge any trade secrets imparted to them. In like manner the owner is bound not to divulge such knowledge after its sale to another. At this point one fact deserves special attention. Trade secrets in themselves are thus recognized as property, and contracts for their sale or complete alienation are not in restraint of trade, because these processes, it is said, must be kept secret to retain their present value.[72] But it is nevertheless obvious that in disposing of such trade advantages, the owner must at the same time part with the patronage which cannot well be separated from the more tangible property; and, however strictly the common law rule of reason is interpreted, it does not prevent the complete alienation of the goodwill. This means that control over different competing trade secrets may pass by purchase into the hands of a single person; for their sale cannot be limited or restrained by law, unless they become thereby the basis of a monopoly. Men are accumulating great fortunes to-day from trade secrets which possess protected advantages of both efficiency and goodwill. That is, the common law thoroughly protects in this manner the efficiency profits of trade secrets; but the entrepreneur may, on the other hand, exploit by shrewd contracts the goodwill and thereby obtain an unearned surplus. There is a huge surplus between the efficiency profit of the secret process, which the entrepreneur obtains under active competition, and his profit at the

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[72] Fowle *v.* Park (1889) 131 U. S. 88, 9 Sup. Ct. 658; Vichery *v.* Welsh (1837) 19 Pick. 523-527; Tode *v.* Gross (1891) 127 N. Y. 480, 28 N. E. 469; Taylor *v.* Blanchard (1866) 13 Allen 375.

point of monopoly at which the law may finally be invoked to curb further accumulation. And there is no natural method of checking this growing restraint of trade or the arbitrary increase in the value of goodwill. It seems necessary, therefore, that the remedies to be recommended in the concluding section be applied where possible to the sale of trade secrets.

In presenting these five contracts, we have revealed the legal conditions under which large unearned surpluses have been accumulated. Whether the present opportunities for commercial exploitation of the public will be lessened depends largely upon the restriction of definite legal and economic forces, which, because of their great influence, are fraught with unusual interest.

It is therefore necessary at this point to submit frankly certain essential remedies which are most pertinent to the issue:

I. In the struggle to control the opportunities of the market, the growth of unearned surpluses from the exploitation of consumers may be checked by *forbidding the sale of goodwill by one competitor to another with an expressed agreement not to enter into competition with him.* Had the learned jurists of the early English common law courts decided once for all that the sale of goodwill by one competitor to another under such circumstances was in restraint of trade, as it undoubtedly was at that time, and consequently illegal, much of the unearned surpluses, which rest directly on such contractual relations would have been prevented thereby. The entrepreneur could, of course, as at the present time, sell an enterprise with its goodwill and immediately set up a similar one in competition with the first. But he would be less willing to sell to a business rival if he could not dispose of the goodwill to a much greater advantage by restraining himself (except in the case of trade secrets) from again entering into competition with him. And the purchaser would not be anxious to secure merely plant and equipment with no legal remedy in case the former owner became an effective competitor. However, the owner would still be at liberty to dispose of his business with its goodwill to a *new investor* and also reasonably restrain his own power of competing with him. Moreover, combinations of plants could also be made for the purpose of securing the economies of large scale production, but without the purchase of goodwill by agreements in restraint of trade. In a word, we have reached here a definite rule: The value of goodwill or patronage among freely competitive enterprises will tend automatically to equal

the normal cost of establishing it, to remain generally distributed among purchasers, and to become stationary even in industrial combinations because of the number of potential competitors.

These goodwill surpluses are in many cases easily recognized. That part of the purchase price which is in excess of the physical value of the plant and equipment, is often paid merely to avoid the competition of a dangerous rival; and the value of the goodwill of the remaining enterprises increases out of all proportion to the number of concerns eliminated. Men are easily lured into combinations by the fascinating prospects of speculative and monopoly gains, which at the same time tend to give to each of the remaining enterprises an artificial value that outweighs all estimates of its actual patronage or goodwill. And the public suffers long before a legal remedy may be applied.

II. American judges are seriously endeavoring to prevent restraint of trade, as they have defined it; but they have failed to see that the producer, who controls from 30 to 60 per cent. of the output of a commodity, is able to regulate price over a wide area and to secure an artificial surplus. Not until recently have courts become aware of the effective restraint upon trade and the serious evils arising from even partial monopolies. Clearly enough, American judges should endeavor to check all restraints upon trade which serve artificially to limit production and increase price.

III. Again, the ancient common law provision against monopolies has been revived in certain states. The Supreme Court of Michigan discovered that the Diamond Match Company had, by this form of contract, closed seventeen plants, and that thirteen factories were made to yield monumental profits for a total of thirty-one companies. The significant fact in this decision is, that the judges were not construing a statute, but were drawing their individual opinions entirely from the ancient principle formerly relied upon in England to check forestalling, engrossing and regrating. Upon this point the statement of Chief Justice Sherwood is clear and concise:

> "All combinations among persons or corporations for the purpose of raising or controlling the prices of merchandise, or any of the necessaries of life, are monopolies, and intolerable; and ought to receive the condemnation of all courts."[73]

[73] Richardson *v.* Buhl (1889) 77 Mich. 633, 658, 659.

IV. The present evolution in the concentration and combination of industry in relation to contractual rights has acquired a legal and economic momentum that cannot be suddenly turned aside. At the same time, these five forms of contract have made possible a complex legal structure which has permitted the industrial liberty of the ancient common law to press beyond its former limits, to become, in many modern instances, legitimate economic piracy. Indeed, the competitive principle in practice has become, through its legal and economic evolution, an engine of destruction. All too frequently it has led to monopoly; and both speculative and monopoly profits still remain securely rooted in legal precedents. But American jurists are rapidly reconstructing and redefining the interpretations of monopoly, and there is a gradual revival of ancient principles which once safeguarded trade.

V. The most important force in this evolution of contractual rights is the tendency of state courts to expand by ever wider interpretations the "rule of reason" in the restraint of trade. And this tendency has constantly received substantial impetus from the more advanced decisions of English cases; the future sales of goodwill may be quadrupled in value by the influence upon state courts of the recent opinion in the Nordenfelt case.[74] Clearly enough, this opinion has practically overthrown the ancient law against restraint of trade. Yet this ruling may so endanger a nation's welfare, by excluding from some essential industry two-thirds of the entrepreneurs best fitted to carry it on, and may so close the avenues of trade and commerce by limiting the number of its enterprises, that a sudden war might make governmental interference necessary.

VI. A distinction has recently been made between combinations, which only restrain trade, and agreements which positively restrict competition. But the usual distinction between restraint of trade and restriction of competition is illogical and unsound from an economic standpoint. The suppression of competition is only another form of trade restriction by which product or price is controlled and an unearned increment is made possible,—that is, a restriction which becomes illegal only when it yields a monopoly profit. But other trade restrictions also serve to create large unearned surpluses, and it is certainly but a question of degree in

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[74] Nordenfelt *v.* Maxim Nordenfelt *etc.* Co., *supra,* footnote 63.

economics whether legal robbery is carried on by shearing the public, collectively under monopoly control, or in smaller groups by partial restraint of trade.

VII. The accumulation of the unearned increment from *partial* restraint of trade has been unduly encouraged by legal decisions. In practice and in theory the entrepreneur has been given a wide scope of legal activity. Innumerable decisions make the profits of able pioneering to include the surpluses of exploitation of another's business or of the goodwill of the public. Sworn evidence of the accumulation of such wealth has disclosed riches which seem fabulous, even in modern times. We still need to revise our right of contract and to loosen the restrictions upon trade and commerce.

VIII. This brings us again to the distinction between efficiency profits and scarcity increments; and it would seem that courts have frequently confused the returns of efficiency with scarcity profits of goodwill. Efficiency profits arise primarily from the advantages embodied in the trade secret itself, while scarcity gains originate in goodwill. As the goodwill of a business cannot well be that of which knowledge is denied the public, it cannot be a part of this process, and may, perhaps, be entirely absent. For example, a secret process or patented article is often sold before it is put to a commercial use; and it may always be distinguished physically from that public regard or esteem which is known in economics as goodwill. The property rights in trade secrets and in goodwill are entirely separate, and judges, statesmen and economists should distinguish, of course, the efficiency profits of the physical process from the vacillating unearned scarcity surplus of goodwill.

IX. Of the five forms of contract, which we have thus briefly surveyed, especially has the fourth been employed to destroy the industrial liberty and independence of individual entrepreneurs. Among the various methods adopted to concentrate into the hands of a few the wealth of a particular industry, this seems to be the most enduring, the most inimical to purely cooperative combinations, the most logical device for perpetuating monopoly.

To some, it seems that the complexity of industry has outrun human ability to analyze it and that the tendency to combination and monopoly is but a natural evolution which society cannot

prevent. However this may be, it is at least plain that the process of elimination, which we have briefly described here, is constantly leaving a smaller number of men who are fitted at the present day to control and direct industry. And a still smaller number remain who have the exceptional means and the hardihood to stem the tide of competition that may be directed deliberately against a vigorous, determined entrepreneur struggling to rise to a position of industrial independence. Consequently, the wealth and power of the few who are not engulfed in the vortex of industrial strife, may threaten in time even the proper functioning of the government itself; and surely the evolution of the common law right of contract has materially aided these men in attaining the goal of their ambition.

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NOTES

Value and Notice in the New York Interpretation of the Negotiable Instruments Law.—In the case of *Kelso and Company* v. *Ellis* (1918) 224 N. Y. 528, 121 N. E. 364, recently decided by the Court of Appeals of New York, two interesting points are brought out; the one, as to the status of a past debt as consideration for a negotiable instrument; the other, as to what constitutes notice of a defense beween the original parties such as to prevent a taker from being a holder in good faith.